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VOL. XXVII

July • 1957

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Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.
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The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

Accounting News And Trends

Introducing the State Banking Department

The Banking Department of New York State has recently issued a booklet, *Introducing the Banking Department of the State of New York*, to give the general public a better understanding of the operations of the Department. Of particular interest to accountants is the description of how a bank is examined. This examination by the bank examiners must take place at least once a year and bears some similarity to the usual audit engagement.

Because the element of surprise is considered an essential factor the examining team arrives before the bank opens and waits for the coming of the officials. Vaults are opened under the supervision of the examiner and all the records and assets of the bank are placed completely under his control. Cash and securities are counted immediately so the bank can open at the usual time. The necessity for speed and completeness at the early stages of the examination require the temporary use of as many as 165 examiners in examining the larger banks.

The chief examiner receives a sworn statement from an officer giving a complete statement of the bank's condition as at the end of the preceding day and this serves as a guide for future computations. Records, assets, and key accounts are not released until they have been reviewed by the examiner.

The examination also includes an analysis of investments and loans. Both their soundness and conformity to banking law and regulations are critically considered. The examiners also act as consultants to management and discuss with the senior officers the findings of the examination.

The work does not end here, for the examiner's report is exhaustively analyzed in

the Banking Department by both a review examiner and a deputy superintendent. A letter is then written to the bank summarizing the principal findings and suggesting any advisable changes of policy or method. To encourage appropriate action, the law requires that this letter and any accompanying statements be presented to the bank's board of directors at their next meeting.

The Accounting Instructor and CPA Experience

The Pennsylvania Institute of CPAs has announced (in *The Pennsylvania CPA Spokesman*, April-May, 1957) the creation of a faculty fellowship program that may presage an era of closer cooperation between the accounting practitioners and educators. The Committee on Education, with the approval of the Council of the Pennsylvania Institute of CPAs, proposes to set up this program to enable younger faculty members to obtain some public accounting experience during the summer months. The Committee's responsibility will be to act as a clearing house and seek to bring together the accounting firms interested in participating and the accounting instructors.

This seems to be an excellent way of aiding the profession by helping teachers with limited professional accounting experience to achieve some necessary practical background. This program was tried on a pilot basis during 1956 and is to be expanded during the 1957 summer period.

Retail Accounting

"Merchandise Management Accounting In Practice" by Robert I. Jones (*The Arthur Andersen Chronicle*, April 1957) suggests a new approach to obtaining costs and profits necessary for merchandising decisions. After pointing out that the selling department has always been the center of responsibility as well as accounting reports, the author suggests there is a danger in having management lean exclusively on departmental averages in making decisions without regard to the profit margins on particular products.

The new concept stressed by the author is that planning and accounting should be centered around individual items of merchandise

Accounting News and Trends is conducted by CHARLES L. SAVAGE, C.P.A. and member of the New York Bar. He is presently serving on the Board of Directors of the Nassau-Suffolk Chapter of our Society.

Dr. Savage is professor of accounting and chairman of the Business Administration Department of Adelphi College.

and that future profit potential rather than historical profitability must be emphasized. In developing this idea, the first step is a reclassification of the usual departmental operating statement so as to make a clear demarcation between controllable and fixed expenses. This would permit determination of the "controllable" profit, i.e., gross profit less variable expenses, which would be meaningful in making merchandising decisions.

It is in the application of this philosophy of controllable profit to individual items of merchandise that the article is particularly helpful. It presents a specific case in which analysis of the major appliance department shows that the hundreds of items can be grouped into some twelve cost patterns. For each pattern it is possible to prepare charts showing the amount of controllable profit at various selling prices. Such information would aid the buyer in negotiating with his supplier, and would also be of benefit to the person responsible for establishing the proper selling price, and management in determining areas in which costs are excessive. This concept of the "cost pattern" being the common denominator of all merchandise activities will make available realistic cost information on an "individual item" basis as compared with the conventional departmental approach.

Competitive Bidding

The North Carolina Association of CPAs has adopted, effective July 1, 1957, a rule of professional conduct prohibiting its members from engaging in competitive bidding. In a letter to the County Commissioners, Mayors, and Superintendents of Education in North Carolina the Association summarizes the new rule as follows:

1. Competitive bidding is not in the public interest.
2. A member shall not enter into bidding for a professional engagement.
3. If a practitioner is solicited to make an offer to perform a service for a stipulated fee, he must directly ask the solicitor if quotations are being sought from other CPAs.
4. Estimates of probable costs at per diem rates may be made where such quotations do not constitute a bid and no maximum fee is quoted for that purpose.

In explaining why this rule applies to governmental agencies in the same manner as any other client, the letter points out these reasons for the existence of the rule:

1. Experience has shown that selection of accountants on a competitive price basis leads to poor quality of work.

2. Comparison of fees is worthless since there is no way to measure the services rendered.

3. Detailed specifications of work to be done give only false security since the auditor must be free to apply his judgment to whatever problems develop during the audit.

4. An accountant should be chosen in the same way as an attorney or doctor, "... choose one in whom you have complete confidence, discuss the work you want done, and agree on a basis for the fee."

Consolidation Accounting

Some interesting variations in consolidation accounting practices are revealed in the *Survey of Consolidated Financial Statement Practices* (August, 1956) conducted by the Research Department of the AICPA. The survey is based on 329 replies to a questionnaire covering 1954 statements. These items seem particularly noteworthy:

1. Somewhat less than one-third of the corporations failed to consolidate their subsidiaries.

2. Where a minority interest existed, the elimination of intercompany profit followed a relatively uniform pattern. The almost universal practice was to eliminate the profit entirely regardless of whether it was originally made by the parent or by the subsidiary.

3. Nearly 70% of the companies surveyed showed the minority interest on the balance sheet by placing it without classification just above the capital stock of the parent.

4. Where the cost of the investment was in excess of the underlying assets, over 40% of the companies charged such excess to earned or capital surplus, a practice, which, since the publication of Bulletin 43, is considered improper. Other practices included the assignment of the excess to specific assets or reflecting the amount as *goodwill*.

5. Where the cost of the investment was less than the underlying assets, the most popular practice was to present the excess as capital surplus.

Costing Joint Products

Costing Joint Products is the title of booklet number 31 (released April 1, 1957) of the Research Series of the National Association of Cost Accountants. The study was derived from interviews with forty companies and analyses of their practices. It does not provide direct answers to specific costing problems but furnishes much useful information

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about how costs have been developed for joint products.

The booklet consists of five chapters. The first is a report summary and the second describes and defines types of joint products. Chapters three and four deal with by-product and co-product accounting and chapter five discusses how joint-cost data may be used by management in planning future activities. These are some of the many items in this booklet that are worthy of comment:

1. Joint costs incurred prior to separation of by-products are charged to the main product. In most cases the values of the by-product are treated as reductions of the cost of the main product.
2. In establishing the value of the by-product, its market price is reduced by any costs of processing or packaging. The entry reducing the cost of the main product is made either upon production or upon sale depending on whether the sale of the by-product is reasonably certain or not.
3. If the by-product is used by the company in place of purchased material, its value is determined by working from the cost of the material replaced.
4. In allocating costs between co-products two types of bases are used: (a) weight, volume, or other common unit of measuring output or (b) market values of the products.
5. The study points out that the individual costs of products produced jointly rest heavily on opinion and should be regarded as approximate.

Aspects of Independence

"Independence-The Broader Concept" by Mr. K. L. Milne (*The Chartered Accountant in Australia*, March 20, 1957) suggests specific situations in which the accountant must show his independence. The article points out that true independence involves far more than adherence to codes of ethics and is rather an aspect of the philosophy that the profession of accountancy is charged with a public trust. Some of the particular aspects discussed are:

When an accountant is asked to perform work on a permanent basis for a competitor of a present client, he should ask the latter's permission before undertaking the engagement. It would also be appropriate to notify the prospective client of his current work for a competitor in case the client would prefer seeking another accountant. If all agree and the engagements are commenced, it is of utmost importance that each client's affairs be kept

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An accountant should never seek reduced prices or special favors from a client because this is obviously demeaning to a professional man. Reciprocal business is to be encouraged but only at regularly established prices. If an accountant expects special reductions from a client, he cannot complain if he, in turn, is asked to lower his fee.

What is the duty of an accountant if his client is violating the law? If the breach involves something less than fraud, for example, charging more than permitted rentals, or failing to comply with certain housing regulations, the matter should be brought to the client's attention. In most cases it will be corrected immediately. If the client persists, and the violation is material, the accountant should resign.

If the client is committing fraud by maintaining false records, and this fact is clear to the accountant, then, of course, he must withdraw from the engagement. The general opinion seems to be that the accountant should not turn informer even if third parties will be injured by the fraud. The information obtained about a client's financial records are strictly confidential and cannot be disclosed unless under direct order of the court. When an accountant discovers fraud and intends to remain silent, he should refuse a fee to avoid the accusation that his silence was purchased.

Accounting Theory and Professional Societies

In his article "The Role of Professional Societies in the Development of Accounting Theory" (*The Accountants' Journal* [New Zealand], February, 1957) Sir Alexander Fitzgerald accomplishes two purposes—(1) he poses the dilemma of the professional society in seeking to stabilize accounting theory without "freezing" standards at an existing level, and (2) he summarizes the publications of the English and American societies that set forth acceptable accounting practices.

The role of the professional societies in the development of accounting theory is not an easy one. The professional body must command respect and general acceptability for its recommendations if it is to lead accounting thought. It cannot achieve this acceptability if it is too dogmatic on controversial issues. But it should not be content to merely accept established practice if it is to lead the profession in constantly changing circumstances.

An Adirondack View

Brainstorms are now acceptable in the best of business circles. At one time they were in ill repute; if you didn't agree with another's ideas about something, the crack to make was, "So you have had another brainstorm!" You also hitched the term to your bridge partner's bids.

But now brainstorms are top-level stuff. If you are really on the ball they are a must—along with a charcoal grill-on-wheels in your back yard.

The first requirement for success in brainstorm sessions is to get the brains. And the second is like unto it, but more difficult—get the brains to working.

If my brains were working, I would list eight more requirements. Lists like this one need to have ten items, to be really high-brow—Moses started this list-of-ten business, remember? So send in your ideas, you might win the grand prize for the best list; you might not, too.

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Letters to the Editor

The Mills Report and Possible 1954 Code Amendments

The Subcommittee on Internal Revenue Taxation of the Ways and Means Committee issued last Fall a list of unintended benefits and hardships, now existing under the Internal Revenue Code of 1954, which it proposed for study and comment. Within the past several weeks, further action has been taken in connection with this report. Certain items have been tentatively approved by the Ways and Means Committee, and others have been deferred for further consideration. While this deferral may very well delay the issuance of a comprehensive statement covering the Committee's proposals, it nevertheless appears quite possible that an act amending the Internal Revenue Code of 1954, and incorporating the changes proposed by the Committee, may be enacted in the not-too-distant future.

Consideration of the proposed areas of possible change is important because of the announced effective dates of the amendments. While the dates will vary, many changes are proposed to be made effective either November 7, 1956 or in some cases for taxable years beginning after December 31, 1956. Thus, taxpayers may already have entered into transactions the tax effect of which could be drastically changed by the proposed amendments. In any event, no tax planning with respect to future transactions may safely be made at this time without giving adequate consideration to these proposals.

The original report lists 33 items for consideration. In view of their importance, I have listed them below in the order in which they appear in that report. The items are:

1. Oil and other mineral production payments.
2. Amortization of premiums on tax-exempt bonds held by dealers.
3. Postponement of gain from sale or exchange to effectuate FCC policies.
4. Transfers of installment obligations to controlled insurance companies.
5. Use of intercorporate dividends received credit in connection with purchases and sales of stock around dividend dates.
6. Transactions in regulated investment company shares around time of distributing capital gain dividends.
7. Use of short sales to postpone recognition of capital gain.
8. Improvements on property subject to renewable leases.
9. Prepaid interest and charitable contributions.
10. Deduction of interest payments while receiving charitable deductions for related interest income.
11. Deductions rather than exclusions for income earned abroad.
12. Depreciation on heavily mortgaged property.
13. Compensation paid largely in annuity contracts by certain tax-exempt organizations.
14. Original issue preferred stock with a high redemption price.
15. Sale of life interests.
16. Multiple trusts.
17. Foreign investment companies.
18. Detached coupon bonds.
19. Amortization of premiums on bonds with call dates.
20. Discount bonds.
21. Interest deductions for loans on annuities and life insurance policies.
22. Variable price restricted stock options.
23. Subsistence allowances received by police.
24. Deductions rather than exclusions for scholarship and fellowship grants.
25. Aggregation of oil and gas property interests.
26. Short-term charitable trusts.
27. Premium payment test on life-insurance policies.
28. "Prohibited transactions" of exempt organizations.
29. Community property.
30. Downward adjustment to basis for certain recognized losses.
31. Tax treatment of proceeds received from certain installment sales.
32. Adjustments required by changes in method of accounting.
33. Election permitting certain proprietorships and partnerships to be taxed as corporations.

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A detailed discussion of each item is set forth in the report. To date, the Ways and Means Committee has taken action on certain of the items and has announced tentative proposed changes. In addition, certain items have been added for consideration, including railroad depreciation allowances, taxation of annuities in community property states, and allowance of an option in determination of a "property" in connection with the taxation of coal, oil and gas, and other mineral companies.

Those areas in which tentative action has already been taken by the Committee relate to the following items which are listed above: 1, 2, 3, 5, 6, 8, 9, 11, 18, 19, 20, 22, 23, and 28.

The Committee has also considered the problems related to prepaid income and reserves for expenses (repealed Sections 452 and 462). Except for a possible provision covering vacation accruals, however, it does not appear that any action will be taken this year in this area.

Consideration is also being given to the subject of administration of the tax law by the Internal Revenue Service. A report, entitled "Internal Revenue Administration," has been issued by the subcommittee studying this subject. The major items of interest in this report cover:

1. Adverse Court decisions—when two or more Courts of Appeals have decided a given issue adverse to the Commissioner's position, he should abandon further litigation and seek legislative clarification of the statute involved.
2. Acquiescences—when the Tax Court decides in favor of the taxpayer, the Commissioner should either follow the decision or appeal it. The policy of neither acquiescing in nor appealing a Tax Court decision leads to confusion and lack of uniformity.
3. Criminal prosecutions—all recommendations for criminal prosecution should be reviewed by the National Office. In this connection, the Subcommittee has suggested that the Commissioner make a study of the desirability of reinstating a policy of voluntary disclosure.
4. Jeopardy assessments—the authority to levy a jeopardy assessment against a taxpayer should be retained by the Commissioner and authorized only by him.

It is not yet known what action will result in this connection during the present year.

In view of the importance of the provisions which may soon be enacted, it would seem desirable for all interested persons to keep the above list in mind and to keep advised of developments related thereto.

DON J. SUMMA, CPA
Chairman, Committee on Federal Taxation

Ordering Federal Income Tax Forms

A Letter from the Regional Commissioner

Last year the New York Region of Internal Revenue Service inaugurated a program of servicing the requirements of practitioners for income tax forms in a more orderly and expeditious manner by providing the accountant with order blank forms. This service was well received by accountants and accounting firms that were solicited.

We plan to expand our service this year to include all members of the profession, many of whom were missed last year. Our mailing will be made about August 9, and will include an explanatory letter and copies of our order blank, NYC Form 9-85B, which will contain a list of "heavy use" income tax forms. We will request the accountants to return the completed order blank to this office by August 19, 1957. Requests for other income tax forms, not listed on the order blanks should be submitted on a letterhead, addressed to the District Office servicing the accountant's city.

The policy of the Internal Revenue Service is that "individuals or firms using income tax forms for private gain shall be given the option of picking up shipments weighing over 4 pounds or having the shipment delivered C.O.D.". Form 9-85B provides space for the accountant to indicate his option.

We would appreciate any publicity you can give this program which permits us to give better service to the accountant with a minimum expense, in time and labor to the Service.

A. W. FLEMING
Regional Commissioner

Ed. Note: As a service both to its members and to the Treasury Department, the Society will enclose with the mailing of the August 1957 issue of the NYCPA, one copy of the explanatory letter and two copies of the order blank form referred to in Mr. Fleming's letter.

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Commendation Overdue

Many members of the Society give freely of their time and energy in professional activities. Few, however, give more than that small group of distinguished members who devote unselfish hours in the preparation of material for this monthly magazine. The members we refer to here are the editors of the several departments of our magazine. They are the ones who do so much for their fellow members by keeping a steady informative flow of current technical material before the readers of our magazine.

For over nine years, Mr. Benjamin Harrow through the "New York State Tax Forum" has kept the membership informed relative to New York State taxation. Mr. Louis H. Rappaport has conducted "Accounting at the SEC" for over seven years. The department "Payroll Tax Notes" has been conducted by Mr. Samuel S. Ress for over six years, and Mr. Max Block has presented comprehensively matters concerning "Administration of a CPA Practice" for more than five years.

Starting this year, Mr. Richard S. Helstein has edited a new department "Federal Income Tax Notes", and Mr. Charles L. Savage a department entitled "Accounting News and Trends." Then, too, we cannot overlook our Adirondack representative, Mr. Leonard Houghton, whose "An Adirondack View" provides a philosophy which has been read with interest for over eight years.

The members of the Committee on Publications feel confident that the membership joins them in expressing sincere gratitude to these members for their outstanding contributions to the advancement of professional knowledge and to the solution of day-to-day accounting problems.

We would also like to congratulate our new Managing Editor, Mr. Benjamin Newman, who took over his responsibilities last October, for the way in which he has carried on and developed our magazine. He has devoted himself unstintingly to his task with energy and imagination.

RAYMOND G. ANKERS, CPA
Chairman, Committee on Publications

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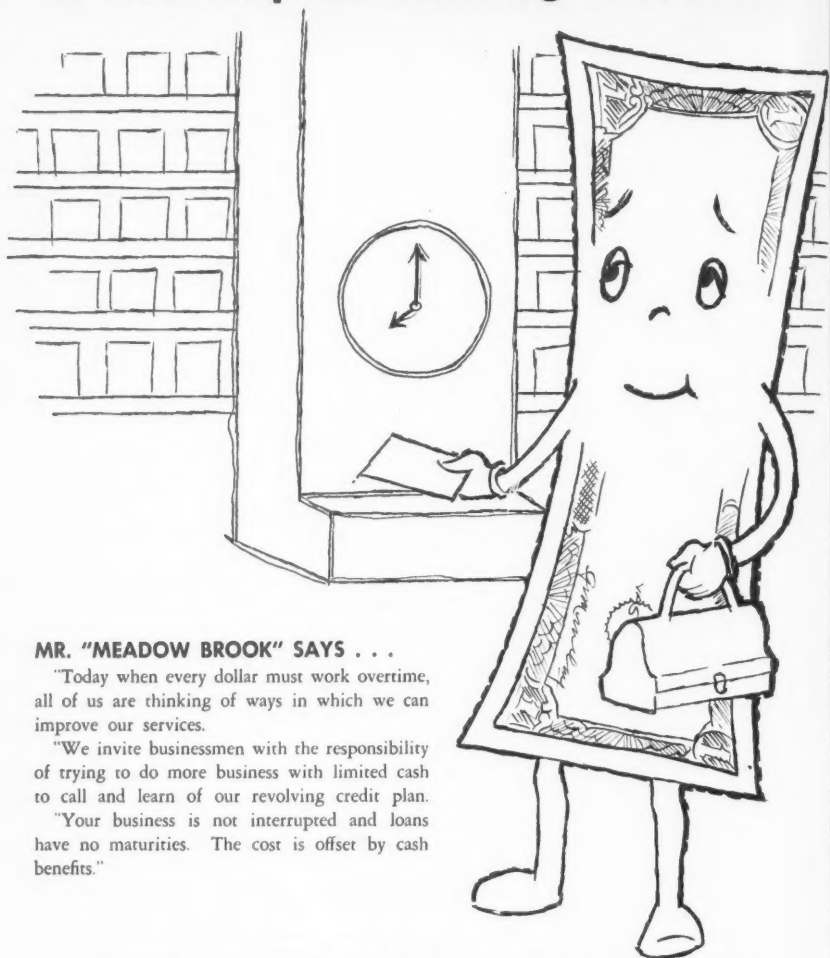
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The President's Page

Technical Meetings

High on our list of objectives for the coming year is the continuation of our Society's program of unremitting effort to provide improved service for our members. One phase of membership service which will receive special attention is our program of technical meetings. In addition to our five general meetings which are devoted to subjects of broad, general interest, we shall schedule a series of technical meetings dealing with matters of more restricted appeal. These meetings will be conducted by our technical committees during October, November, December, April and May.

Last year there were twenty-five such meetings covering a wide variety of subjects ranging from entertainment and sports accounting to the always popular subject of federal taxation. Attendance was rarely less than one hundred and went as high as eight hundred for the tax meetings. But attendance is not all-important. We submit that if there are only twenty-five members of our Society who will receive a genuine benefit from the discussions at a particular technical meeting, that is ample justification for holding such meeting. On the other hand, where the scope of a meeting is such that it should attract thousands and only hundreds attend, something is wrong.

The problems attendant upon the scheduling of these meetings are many. Naturally, in the limited period available not every committee can conduct a meeting each year. Nor does the scope of every committee warrant such frequent coverage. But emphasis should be placed on those fields and

The President's Page

subjects which hold the greatest interest. With this in mind, a questionnaire was recently sent by the Meetings Committee to all members in the Metropolitan Area requesting an expression of opinion as to the technical committees which they preferred for the conduct of the meetings. Additional questions were asked to ascertain preferences as to type of program, time and dates of meetings. The response to the questionnaire was most gratifying and the answers and suggestions will enable us to give more members more of what they would like.

Naturally, all of us are not interested in all of the technical meetings. Nor are we free to attend all even if we wished. But too many of those answering the question as to why they did not attend admitted that it was not because of lack of interest, lack of time or lack of opportunity but rather to inertia. This is truly disturbing! We urge you not to overlook the advantages of our technical meetings program and not to let oversight or neglect keep you from attending. It has frequently been said that one new fact or one new idea gained from one meeting justifies attendance at many. Don't allow that new idea to escape you!

Meetings will be announced well in advance with reminders placed in our newsletter and other releases. Won't you try to calendar those you wish to attend as soon as they are announced so that they are not overlooked in the hustle and bustle of our busy professional lives. Our meetings are synonymous with continuing professional education and carry with them values which are reflections of the economic, intellectual and spiritual aspects of our professional lives.

LEONARD PRICE,
President

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The Accounting Profession's Growing Interest in Statistical Sampling

By ALDEN C. SMITH, C.P.A.

Although it would be currently premature for the profession to take a definite position as to the applicability of statistical sampling to auditing, this relatively new subject warrants active exploration as to its possibilities and benefits.

The origin of the traditional testing and sampling methods in auditing appears to have paralleled the development of business organizations from the small proprietor to the large corporations of today. With the increasing importance of the corporate form of organization after 1900, the emphasis in auditing gradually shifted from engagements thought to require 100% inspection, such as the determination of individual proprietary interest, bankruptcy proceedings and the administration of trust estates, to the examination of large enterprises for the purpose of expressing an opinion on the financial statements. The larger enterprise has made it possible to establish internal accounting controls, so it is no longer necessary to employ outside auditors to balance the

books and check all the detail postings as had formerly been the case. Also, emphasis on the detection of fraud, which as late as 1914 was considered to be the primary purpose of an audit, has gradually been modified so that the primary purpose of an independent accountant's examination is now viewed as the expression of an opinion as to the financial statements.

The Traditional View of Testing and Sampling

References to test checks appear frequently in literature published in the 1890's and the early 1900's, but there is seldom any reference to the extent of the test check considered desirable or the method to be used in making a selection. An article published in 1905 ("Detail Checking" by W. Strachan, *The Incorporated Accountants' Journal*, December 1905) mentions a preference for an extensive test of one month's transactions as opposed to a less thorough perusal of all transactions recorded during the period. Another writer (Richard A. Witty in *The Incorporated Accountants'*

ALDEN C. SMITH, C.P.A., is chairman of our Society's Advisory Committee on Application of Statistical Sampling to Accounting and Auditing. The author is a past President of our Society and a partner in the firm of Price Waterhouse & Co.

The Accounting Profession's Growing Interest in Statistical Sampling

Journal, December 1905) advocated the selection "in a haphazard manner" of items to be subjected to a thorough check.

Little progress has been made in the definition of testing and sampling to the present time. The pamphlet "Generally Accepted Auditing Standards" published by the American Institute of Accountants states merely: "The testing technique rests for its justification upon its reasonableness." The pamphlet "Audits by Certified Public Accountants" published by the American Institute of Accountants, in dealing with auditing philosophy states:

"The extent of testing in any audit is decided by the C.P.A. in the light of his best independent judgment as to the amount required to constitute a fair sampling of the records being tested."

The Growing Interest of the Auditor in Statistical Sampling

Perhaps the first article advocating the application of statistical sampling techniques to test checking by auditors was "The Efficacy of Tests" by Lewis A. Carman, which was published in *The American Accountant* in December 1933. In recent years such articles have appeared with increasing frequency.

Due to the increasing interest in this subject, the New York State Society of Certified Public Accountants in 1955 formed an Advisory Committee on Application of Statistical Sampling to Accounting and Auditing. This was the first committee of this type to be created by any of the State C.P.A. societies in this country. In 1956 the American Institute of Accountants appointed a Committee on Statistical Sampling which has embarked on a program to study various aspects of this subject. A similar committee has been established by the Institute of Internal Auditors.

The subject of statistical sampling is also receiving attention in other countries as is evidenced by the fact that a Swedish Foundation for accounting and auditing research work has decided to grant funds for a scientific investigation of the use of statistical methods for selection of tests in connection with auditing. A recent *Journal of the Royal Statistical Society* published in London states:

"There has recently been a considerable awakening of interest in the possible application of statistical techniques, in particular sampling methods, to accounting records."

The Need to Explore the Potential of the Newer Methods

It would seem to be premature for our profession to presently take the position that generally accepted auditing standards should incorporate the application of statistical sampling to certain testing and sampling procedures. However, it would be equivalent to burying one's head in the sand to ignore the possibility of applying these techniques to certain phases of our audit testing and sampling procedures. The accounting profession has been accused, at least by inference, of basing its conclusions on sampling methods which are not scientifically accurate, while more "precise" methods in the form of statistical application are available for its use. For this reason it is essential that the independent auditor, the internal auditor and the accounting personnel in private companies take an active interest in the subject of statistical sampling and acquaint themselves with its possibilities. In order to accomplish this, they should read some of the literature on the subject, actively explore the possibility of applying some of the techniques in their auditing work and participate in discus-

sions with their associates as to the potential of this relatively new subject.

There is an increasing body of opinion in the auditing and accounting profession which believes that the application of statistical sampling techniques to auditing and accounting affords the profession an opportunity to restudy and re-evaluate not only our present auditing techniques with respect to testing and sampling but, supplementarily, the basic reasons and purposes of such procedures. Two of the most fundamental and yet simple applications of statistical sampling relate to the choice of the proper field for testing and sampling and the selection of the items in that field on an objective basis. Every auditor should be interested in these phases of his examination, and I suggest this as the initial step in his becoming acquainted with this subject. I feel that once started he will find the subject sufficiently intriguing so that he will wish to carry his study and experiment into various phases of the examination, with the result that many of the mysteries may tend to disappear.

Not only should the profession study the application of statistical sampling techniques in order to obtain benefit therefrom in its testing and sampling procedures, but we must not ignore the possibility of obtaining greater protection in court proceedings through the use of tests which may be properly supported by recognized statistical methods that permit the evaluation of the results of our work.

Judgment Not Supplanted

One of the misunderstandings which many auditors have with respect to statistical sampling is that it contemplates supplanting the judgment factor in an auditor's work by statistics. Even a cursory study of this subject would tend to dissipate this viewpoint. While statistical sampling does, in certain areas, take the place of what the auditor has commonly referred to as the exercise of judgment, it may place a greater premium on this factor than is presently being exercised. While the need to determine a proper field may arise from the theory of statistical sampling, the determination of the field is a matter of judgment. The choice of the samples to be tested may be determined by statistical methods, but the number is a matter of judgment. Even the most ardent advocate of statistical methods has to use judgment to define the risks he is willing to accept. The analysis of the result of the test places a great responsibility on the judgment of the auditor in that he must determine whether it satisfies the purpose of the audit step or whether supplemental procedures are required. Statistical sampling, in eliminating biased or haphazard selection, serves as a tool of judgment and not as a replacement thereof.

The article by Dr. Herbert Arkin on Statistical Sampling in Auditing in this issue of *The New York Certified Public Accountant* deserves careful reading and searching inquiry on the part of every public accountant.

Statistical Sampling in Auditing

By HERBERT ARKIN

A noted statistician offers a comprehensive analysis of a variety of statistical techniques which have been suggested for use by independent accountants in audit sampling.

In the last few years there has been a veritable explosion of literature and discussion on the application of statistical sampling methods to the testing technique utilized in auditing. Committees have been formed by the American Institute of Accountants and the New York State Society of Certified Public Accountants to investigate the problem. Independent auditors have been experimenting with, and some have adopted, the methods of statistical sampling. Organizations using internal auditing methods have turned to these techniques in increasing numbers. This accelerated study of this subject is symptomatic of the increasing interest arising from a re-evaluation of existing test methods in

the light of modern knowledge of sampling theory.

Testing vs. the Detailed Examination

In the early stages of the development of the independent audit, which culminated in its widespread acceptance in our modern economy, it was not uncommon practice for an auditor to perform a 100% examination of the entries and records of the company audited. However, as our economy grew and large-scale enterprise put in its appearance, it quickly became apparent that a 100% examination of the tremendous volume of entries, with the resulting subdivision of accounting duties, was unwarranted and uneconomical. The auditor's only possible recourse, which would provide him with reasonable assurance as to the validity of the entries in the books of account, was to examine a portion of the entries or records—in effect, a spot check. This developed into the “test” or “test check” approach which is both widely accepted and widely used in auditing.

It is quite obvious that such a method, involving the examination of a portion of a larger mass of entries, is a sampling operation, even though the word “sample” is not generally used in con-

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nection with the test. This brings to mind the fact that in the last few decades the statisticians have laboriously developed an elaborate set of techniques for dealing with the problems of sampling, techniques which have achieved wide acceptance in other fields.

Uniqueness of the Problem

Part of the reason for the failure of statistical sampling methods to permeate the field of auditing more quickly arises from the unique nature of the sampling problem which confronts the auditor. In the forefront of the unusual characteristics of the auditor's sampling problem is the fact that the auditor does not place sole reliance upon or base his final decisions exclusively upon the results of a single test. The evidence obtained from each test is evaluated together with the results of other tests and other types of examinations and explorations. In this respect, the auditor's sampling operation differs greatly from that encountered in other fields. Thus, it becomes imperative that sampling techniques be designed to meet the specific need of the auditor. Before examining the possible approaches to this problem, it might be well to observe the current position of the auditor with respect to this test method.

Current Position of the Auditor

As noted previously, the auditor examines a sample of the entries or records with the intent of achieving assurance as to the substantial and overall validity of the entries in the books of account and the resulting financial statements. It is obvious that the assurance provided by the auditor's test check will be a function of the adequacy of his sampling method. In its discussion of testing methods, the publication of the American Institute of Accountants, *Generally Accepted Auditing Standards*, states that

"the testing technique rests for its justification upon its reasonableness . . ." It further notes that "there is no magic formula by which a proper degree of testing may be established any more than there is a uniformly satisfactory method of selecting the audit procedures which are appropriate."

The same publication contains the further statement that the "appropriate degree of testing will be that which may reasonably be relied upon to bring to light errors in about the same proportion as they would exist in the whole of the records being tested." If this statement is taken literally, a rigorous sampling requirement is imposed. It is only through the application of statistical sampling techniques of the highest order that such a desirable objective can be achieved. Certainly, test methods involving judgment sampling methods cannot be employed to attain such a difficult goal.

In general, the accounting profession has not fully realized that during the past fifty years a body of knowledge generally referred to as sampling theory and practice has been developed on a scientific basis. This sampling knowledge has been widely applied in all fields. Not only has it found wide acceptance and application in the sciences, but in industry and business as well. For instance, billions of dollars of delivered merchandise are accepted or rejected on the basis of statistical sampling plans which are written into the contracts with the vendors. Many government defense contracts contain such clauses. However, since auditing is looked upon as an art and not a science, auditors have not searched out these methods.

Scientific Sampling

But why is scientific sampling necessary? The basic reasons for the use of

Statistical Sampling in Auditing

adequate and objective sampling methods are twofold:

1. To secure reliable and not misleading assurance as to the state of the accounts.

2. To have a defensible method of sampling.

Many of the test methods now being used can provide a false assurance as to the accuracy of the accounts, primarily because the test is based on a method of sampling which may be inadequate to disclose existing errors. It is far better not to sample at all than to select data in such a manner that it will give rise to a false assurance of accuracy. Moreover, by traditional sampling methods the auditor is not in a position to defend his test methods, whether it be before a court of law, his superiors or the public. It may be noted that in other fields judicial bodies have recognized the fact that statistical sampling is the proper approach to be used in obtaining data which are to be used as evidence when sample data must be used. If the sampling method is left entirely to the discretion of the auditor, as it is now, it is obvious that different auditors will arrive at widely different sampling methods for the same situation. To be defensible, the test method must be (1) objective and (2) have a common set of principles.

The requirement that a test method be objective merely means that the manner of sampling must not be dependent on the auditor's judgment of the moment, but must be similar, at least in approach, for all. The second requirement merely states that there actually must be some basis for the method of sampling beyond the subjective judgment of the particular auditor or an historical accident.

It might be well to consider here the basis of a sampling method which will

meet the above requirements. It is provided by the statistical theory of sampling which in turn is founded on the mathematical theory of probability. It is not necessary for the auditor to become alarmed at this point. The auditor need not become a mathematician or a statistician although it is desirable that he understand the general principles he is using. Nor will any mechanical method for supplanting the auditor's judgment be proposed. A new tool is presented which will better enable him to exercise that judgment.

Decisions Required in Sampling Plan

A sound sampling method requires certain decisions:

1. What is to be sampled.
2. How it is to be sampled.
3. How much is to be sampled.
4. How the sample results are to be appraised.

These decisions result in the sampling plan or the plan for the execution of the test. The decision as to what is to be sampled is, of course, purely in the province of the auditor's judgment. The entries or records to be tested must be decided upon by the auditor. However, as will be seen later, the objectives sought by the auditor will definitely affect the sampling plan.

The "how" of the sampling method is of first importance. The mechanics of sampling may well decide the success or failure of the test in providing the auditor with the desired assurance. Mathematical theory can provide the protection as to the interpretation of the results of samples only if the sample is drawn on a random (or probability) basis. This randomness of choice must be real. Randomness cannot be provided by a mere haphazard choice. Nor

do practices such as taking a group of accounts out of one or two ledgers, or selecting a part of or even all the entries for a *selected period of time*, provide such protection.

Pure randomness is necessary. Randomness provides not only an objective choice of the sample items (since it entirely removes from the auditor the choice of the items to be checked) but also a complete surprise element which cannot be circumvented by the fraud-minded individual, as well as an assurance of the desired representativeness promised by mathematical theory.

Randomness of Selection

It might be well to define what is meant by random choice here. Essentially it means that each of the items in the group or sub-group being sampled has an equal opportunity for inclusion in the sample. Haphazard choice without intent to select does not provide randomness. The selection of items to be included in the sample can easily be biased without any deliberate intent to do so. It is amazing how biases creep in, in spite of best intentions. The mere fact that no bias was intended provides no protection. We are all human and susceptible to temptations and other human foibles. For instance, set a junior to work on a group of vouchers with instructions to choose at random. Careful study will probably indicate a tendency towards avoidance of the more complicated or lengthy vouchers.

How then can a truly random and unbiased choice be made? Several methods are available. Two major classifications of these methods may be made.

1. Unrestricted random sampling.
2. Systematic sampling.

In its simplest form, unrestricted random sampling would consist of thor-

oughly mixing up in a hat the slips representing the entries to be sampled, and grabbing a handful—not a very practical approach and one which can be biased if great care is not exercised. Better methods of accomplishing this end have been provided by tables of random numbers. If the documents or entries to be sampled have been numbered, such as account number, page number, etc., this method may be used.

A sample of a portion of a page taken from a random number table is shown as Table I (page 458). The sampler may combine the digits shown to provide a number of sufficient digits to cover the range of the item numbers to be sampled. For instance, if the records to be sampled range in number from 2622 to 8865 a four-digit number will be used. This four-digit number is obtained by combining columns of digits in any manner. While the digits in this table are grouped in fives for the purpose of ease in reading, any set of groups of four may be used. Thus, starting with the first column of groupings, the first sample number may be taken as the last four digits of the group or 3831 (first column, first row). This record or entry will then be included in the sample. The next item number to be selected is 5465 (first column, second row), etc.

If a sample number outside the range of the numbers to be used is encountered, it is ignored and the next number used in its place. If a duplicate number arises, it is ignored. The numbers drawn then comprise the numbers of the items to be included in the sample.

Systematic Sampling

Where items are not or cannot be numbered or the costs of pulling the selected documents are too great, systematic sampling may be used. Systematic sampling consists of selecting every *n*th

Statistical Sampling in Auditing

item out of the series of entries or records using a random start. For instance, if accounts receivable are being sampled for the purpose of confirmation, and it is desired to select a sample of 200 accounts out of 4000, every 20th account may be used by selection from a list or file of these accounts providing the starting point is a random selection from among the first 20.

This method is generally a less costly method than the use of random numbers but there are certain inherent dangers when the method is not carefully used. When using this method of sampling great care must be exercised that there

is no arrangement of the sequence of entries that might introduce a bias into the sample. For instance, in sampling a payroll, if every 20th payroll number is taken and the sequence of the payroll is such that every 20th payroll number is an assistant foreman, and if the random start hits upon an assistant foreman, only entries for these assistant foremen will be tested. If the random start happens to fall on other than an assistant foreman, none of these lines will be included in a test.

While this is an apparent danger, there are other instances when less obvious dangers of bias are introduced by

Table I
TABLE OF RANDOM DIGITS

04800	73831	87202	27346	42658	51948	38726	67360	35815	18792	76264
04801	65465	26365	80200	45336	46016	24437	61384	38839	69168	83777
04802	98955	82357	80400	73053	19430	46868	99858	51892	00077	58012
04803	34797	71994	96962	18361	95116	90743	34025	14492	90532	00041
04804	90650	04701	16569	04723	35509	67283	51736	44666	58261	80604
04805	31247	38088	28686	51435	47978	06875	67232	57212	34623	14546
04806	45081	30791	61840	04458	05667	21213	92997	00965	97809	26270
04807	08987	01058	58777	64807	31668	04621	93798	54435	06558	82608
04808	62598	19741	70363	20838	28054	64435	87525	26052	85354	02547
04809	00033	73503	70553	60008	62915	52836	20419	64342	82251	75692
04810	52763	53788	33344	93499	42232	85468	55404	21294	17285	49489
04811	97878	97853	76376	17352	79250	60879	75135	97473	33288	68080
04812	99391	91462	97370	44776	78311	53732	10635	31005	07654	76811
04813	65090	94827	79573	01053	31204	42038	73777	59818	23569	58109
04814	42280	96162	35946	30097	13326	02838	22111	97143	17085	66854
04815	12069	58506	73031	15132	74172	36630	54994	03400	82628	09339
04816	91617	20793	07798	37615	29403	92357	83551	41692	50328	21412
04817	87040	39291	02576	33545	77386	30841	05206	08838	91607	08366
04818	70903	64924	80144	91232	46165	13197	22528	58269	38897	25113
04819	35990	95773	57107	60053	94567	55974	40237	81553	05368	72120
04820	90109	22578	21653	76800	37430	82842	23888	60924	38698	70997
04821	95376	62519	86296	47616	31549	54788	80346	45737	08185	45779
04822	23496	71867	55843	59259	93602	43541	17042	50541	06527	09009
04823	66037	19952	70017	47836	22271	54216	42186	90820	77460	75942
04824	08222	87515	50667	89916	24842	80389	57695	01331	59745	07576

Source: Rand Corporation, *A Million Random Digits*, The Free Press, Glencoe, Ill., 1955, p. 97.

the arrangement of the items. However, there are techniques which can be used to overcome these difficulties. For instance, avoidance of the effect of a cyclical arrangement can be accomplished by using several random starts with the use of every Nth item after each start. If the sequence of items show no cyclical arrangement or if there is at least some assurance to that effect, systematic sampling will be as good an approach as that attained through random numbers.

It may be emphasized here that success of sampling also will depend on the proper definition of the field which is to be sampled. Careful consideration of the objectives of a test will enable the auditor to decide on his definition of the field or, as the statistician would term it, the "frame."

In summary it may be said that the advantages of objective sampling are:

1. A method which would provide the protection afforded by mathematical theory and a representative sample.

2. A defensible system of sampling.

3. A complete surprise element to confound the fraud minded.

To which may now be added

4. A method which will enable advance determination of the sample size to achieve any given level of accuracy.

Before considering the question of sample size and the sampling plan, there are certain other questions which might be raised.

Testing Selected Periods or Areas

It is common practice in auditing to use as the basis for a test, a sample selected from the entries for a particular month, week or day (or all of the data for that limited period). This practice is quite universal. Examination of the case studies published by the A.I.A. dis-

closes that the practice is not only common but that there is a pattern in the selection of the months. Upon occasion the selection of a period such as a year-end date is deliberate in order to validate a balance as of that time. However, the period of time is usually chosen because it is considered a sample of the entire year. After all, it is much more convenient to draw from entries confined to a limited period of time, than to search for a sample spread across an entire year!

The result of such a sampling, providing an objective sample has been used, is a perfectly valid evaluation of the accuracy of these records *but it may be applied only to that month, week or day only, and does not of necessity apply to the rest of the year.* The auditor must ask himself "Am I satisfied with the fact that the entries for November were accurate or must I concern myself with the entire year?" If, as often happens, there have been changes in personnel or changes in the nature of the workload, the conclusions based on a sample for November do not validate the work for the balance of the year. Further, even if these changes do not occur, is there any certainty that the quality of the work done remained the same throughout the year?

In a similar manner, when auditing an organization with a broad geographic distribution, it is not uncommon practice for the auditors to select records or entries for a limited area as a basis for their sampling. Again, conclusions based on such a sample are applicable to that area alone. In this instance, the argument may be propounded that, after all, the audit is a continuing one and that sooner or later all areas would be covered. Not only is the surprise element lost here, but the conclusion drawn may well be fallacious.

As a further example, consider the case of the company with a large number of bank accounts and the problem of their reconciliation. Shall a sample of the accounts be taken by randomly selecting a month and reconciling a sample of the accounts for that month? The question here is what are the basic sampling units. What is the definition of the field? Actually, assurance as to the accuracy of all statements for all months may be the objective. Thus, if there are 100 accounts we are actually investigating a field of 1200, i.e. 100 accounts for each of 12 months and the sampling must be accomplished by random selection from the 1200 sampling units, not the 100 accounts for one month.

Of course, there will be complaint by some that this will either increase the difficulty of the work or its cost. Experience shows that it makes little difference. But even if it did, it is better to have no sample at all than one which gives a false assurance of accuracy which may not actually be warranted.

Stratified Sampling

Another problem which may confront the auditor when he attempts a test is the fact that he may not consider all accounts or records of equal importance. For instance, he may have a much greater interest in establishing the accuracy of large accounts and thus be unwilling to run as great a sampling risk for this type of account. Objective sampling methods do not of necessity require sampling from a general pool of all items. It is not only possible, but often desirable to segregate accounts into separate groups, say by size or other characteristic, and to sample to various degrees in each area separately. For example, it may be desirable to audit all accounts with balances of more than

a certain amount and to sample others, a common and perfectly valid practice, providing all sampling is on an objective basis. This technique of using separate sampling ratios for different groups of items is known as stratified sampling.

The Appropriate Sample Size

The subject of the appropriate sample size while complex from the statistician's viewpoint may be resolved without too much difficulty on behalf of the auditor. It must be recognized that reliance upon a sample rather than examination of all the data involves a risk. This risk exists even though the sample consists of 99 items out of 100. When the sample has been secured by the objective methods outlined previously, namely by use of a random sample, it is possible to determine in advance the extent of that risk or conversely to select a sample size to fix the risk.

Before delving further into this subject however, it might be desirable to examine a popular superstition about sampling. There is a general belief that if we always use some fixed percentage of the sample, say 10%, we will always have the same degree of assurance from that sample. Nothing could be further from the truth. For instance, a statistician could determine that in order to estimate the occurrence of errors to within 2% when 25,000 entries are to be sampled, a sample of 835 would be required for a given risk, while for 100,000 entries only 857 are needed. The invalidity of the 10% sampling theory may be seen if one considers a 10% sample from a field of 10, or only 1 item, as contrasted with a 10% sample from a field of 1,000 or even 100 items. Generally speaking, it is the *absolute* size of the sample that counts the most, not its size in relation to the field to be sampled. This latter factor has much less importance.

A corollary of this may be illustrated. Assume that it is desired to estimate the accuracy of the work of several bookkeepers in one department or, on the other hand, to secure an overall estimate for the whole department. The sample size needed for *each* bookkeeper will be practically the same size as that for the whole department. This must be borne in mind when fixing sample sizes for various purposes. The determination of appropriate sample sizes is a function of the objectives of the sampling as well as the risk to be undertaken.

The purposes of the test or sample in independent auditing may be specified as:

1. Extent of failures to conform to prescribed internal control procedures and/or established accounting practices.
2. Frequency of occurrence of material errors.
3. Evidence of fraud or manipulations.

The sampling method may be different in each case. For instance, in examining extent of failures to conform to internal control, the objective may be to ascertain the relative frequency of departures from prescribed procedures or merely to sample sufficiently to find at least one example of such a departure if it does occur. The same may be true of the other areas. However, in the case of fraud or manipulations, it is usually sufficient to find just *one* instance in order to precipitate an investigation. Appropriate tables prepared by statisticians may be used as a guide for such purposes. Before examining examples of such tables, a further word about the risks of sampling.

The Element of Risk

As mentioned before, the use of any sample, no matter how large, involves

a risk since all of the data were not examined. However, it is equally true although not generally recognized that examination of all of a large mass of data also involves a risk, although of a different nature. For instance, it has been shown, as one might expect, that careful examination of a smaller sample of data rather than a laborious examination of a massive number of items is less likely to result in failures to detect existing errors. Thus, the expenditure of one-third of the time on the examination of a sample one tenth of the size of the field may well disclose errors which might be overlooked in a complete examination. The risks are not all on the side of the sample.

A considerable advantage of the sampling method is that when an objective sample is used, the unknown risk of overlooking errors in a total examination can be replaced by a calculated risk of the sample. That is the function of the statistical approach. It provides a calculated known risk. At the same time it forces the sampler to recognize the risk. The risk the auditor is willing to run in depending on the sample results must be established by him on the basis of his judgment aided by his knowledge of the internal control system and his other procedures. It is this determination of risk which fixes the sample size and the entire sampling plan.

Once the risk is selected, several possible approaches are available. Since there is a certain amount of controversy about the correct approach to be used, each of these possible approaches are explored in detail. The possible approaches available to the auditor are:

1. Acceptance sampling.
2. Appraisal or estimation sampling.
3. Discovery sampling.

Statistical Sampling in Auditing

Acceptance Sampling

The first two of these approaches, acceptance sampling and appraisal sampling, have much the same objectives and may be considered alternatively for the same purpose. Discovery sampling has a unique purpose which we will consider later.

To simplify the discussion, consider the use of these approaches in investigating the frequency of occurrence of disparities or departures from internal control requirements rather than the magnitude of these errors or disparities. The problem of dealing with magnitudes or the amount of the errors rather than frequencies will be considered later. In its simplest form, the acceptance sampling approach, which has been borrowed from industrial quality control inspection of incoming lots of materials, indicates that from a field of a given size, a given number of entries will be selected at random and if the sample contains more than a certain minimum number of disparities, the field would be "rejected" as containing too large a proportion of errors. To the auditor this would mean that further investigation and possibly further sampling is required.

If fewer than the specified number of errors (however defined) are discovered in the sample, the field will be accepted as satisfactory. It is evident that the use of such an approach requires a decision by the auditor, in advance of the sampling, as to the maximum proportion of errors that would be permissible in the field. It must be emphasized that sampling risks exist here too and must be considered in selecting the appropriate sampling plan. The sampling plan necessary to accomplish the auditor's purpose can be obtained from an appropriate table. While existing tables are not designed properly for this

purpose, adequate sampling plan tables can be created to meet the need of auditors.

In order to make use of such a method, the auditor must decide on the maximum permissible level of frequency of error. The plan will be designed to provide a certain protection against the "acceptance" of fields with greater frequency of occurrence of disparities than this level permits. However, since this is a sampling operation and not a complete inspection, certain risks are involved. These risks are essentially twofold, a risk of "accepting" a field containing a greater proportion of error than that specified as the maximum permissible and a risk of "rejecting" a field containing less than the permissible maximum. Tables can be provided which will reduce these risks to any desired level.

For instance, let it be assumed that it is desired that the auditor assure himself that a test of a field of 10,000 vouchers will be rejected if the field contains in excess of 6% of errors. It is further desired that there be at least a 95% chance of rejecting the field if it contains that proportion or more of errors. In addition, it is specified that there must be virtual certainty (99 chances in 100) of accepting the field if it contains as few as 2% of errors. The required sampling plan will then indicate that the auditor is to select a random sample of 340 items and if more than 19 are in error he will reject the field, if not he will accept it. It is to be noted that the result provides an indication only that the frequency of error is in excess of the maximum tolerable level and gives no indication of the actual level of occurrence of disparities as would be determined by estimation sampling methods, later explained.

The Limitations of Acceptance Sampling

Once the sampling plan is selected, the operation of the method certainly sounds simple. This simplicity, together with certain other factors, is apt to commend this method to the auditor at first glance. However, there are certain considerations which lead to questioning this method as an appropriate approach to the auditor's problem. One of the major reasons for the impression of desirability of this type of approach lies in the early history of the attempts to apply statistical sampling to auditing problems.

The first book dealing with the problem of statistical sampling in auditing "The Scientific Method for Auditing" by L. L. Vance (University of California Press) was published in 1951. Vance was apparently much impressed by the parallel between the auditing test problem and the problem of approving or rejecting lots of merchandise by the use of samples as was commonly practiced in industry under the title of industrial acceptance sampling. Here the recipient of the lot by examining a sample taken from that lot and determining whether the sample contained more than a certain specified number of defectives, made a decision as to the acceptance or rejection of the lot. Apparently he was so impressed with this technique that he borrowed it bodily from industry and proposed its use for the auditing test. While we must be grateful to Vance for his pioneering venture and the resulting impetus it gave to the use of statistical sampling, there is some question as to the appropriateness of this approach. Unfortunately, many of the later articles have dealt with this subject as though this were the only approach.

To use this approach, the auditor must decide *in advance* as to the maximum

permissible frequency of occurrence of errors. This is a very difficult advance decision especially in view of the fact that he has no advance information on the nature of these errors or their magnitude. Next, the auditor must make a decision as to the risk he is willing to run of failing to reject a field which actually contains as much as the maximum permissible proportion of errors. Existing industrial quality control acceptance sampling tables, such as the well known *Dodge Romig* table, automatically fix this risk at 10%. This means that if these existing tables are used the auditor will fail to reject a field containing a proportion just beyond that maximum permissible proportion of error in one out of every 10 tests. Of course, if the field contains much more than this maximum permissible error, the probability that it will pass the test will be much smaller, but will nevertheless exist. This would indicate that existing tables are not precisely appropriate for the auditor.

In this type of approach, there is another risk, although not usually specified by the table. This is the risk that fields containing *fewer* than the maximum permissible proportion of errors will nevertheless be rejected. For instance, a field containing just under the maximum proportion of errors may have almost a 90% probability of rejection.

While a discussion of the pros and cons of acceptance sampling as a tool in auditing is perhaps premature in a first discussion of this subject, there are so many who have been favorably impressed by this suggestion, that a more extended discussion may be justified. Therefore, this controversy will be dealt with in detail before suggesting other methods which seem to be more appropriate. To understand the nature of the difficulty, it might be well to examine the use of this method in industry.

Acceptance Sampling—Industrial
vs. Auditing

The prime objective of industrial acceptance sampling is the rejection of bad lots of purchased materials. The purchaser is primarily concerned with the rejection of very bad lots and, while he wishes to eliminate them, he is not too much bothered about moderately bad lots. He expects to accept some of these moderately bad lots, as well as a few very bad ones. He also expects to, and can afford to, reject a few good lots due to sampling fluctuations. These risks are recognized and computed in quality control acceptance sampling.

In general, those using industrial acceptance sampling, sample lots from the *same vendor* numerous times within a relatively short period of time. They are satisfied if they *average* out to a desirable quality level for a number of lots although they will take special steps to avoid extremely bad lots. The auditor samples but *once*, in most instances, for a given audit.

If industrial acceptance sampling indicates a lot to be bad, the possible courses of action are:

1. Return the lot to the vendor; or
2. Screen the lot by 100% inspection; or
3. Use it anyway.

By contrast, the objective of the auditor in his sampling test is to evaluate the quality of the accounting work done, to appraise the effectiveness of the operation of the internal control system, the frequency of occurrence of material errors and to seek possible evidence of fraud. His is not the task of acceptance and rejection of defects at a specific percentage point with small concern about moderately bad situations. If the auditor's appraisal indicates trouble, his

action is to enlarge his investigation, to analyze the nature and impact of the defects and their cause; not merely a "send it back" or "do it over" attitude. This difference, both in objectives and actions subsequent to sampling, requires a somewhat different approach to the auditor's sampling problem. We cannot adopt bodily existent quality control acceptance sampling methods merely because they are readily available. We must appraise the methods in the light of the new objectives and, although we use the same basic principles, we must design methods which will best serve the auditor's needs.

Another basic difference in the two situations is in the nature of the defects. The purchaser of physical materials has a set of specifications and tolerances for the materials purchased for characteristics such as thickness, length, strength and other physical properties. He knows that if a micrometer is applied to each item of the sample, he will be able to determine whether or not the item is within the specified tolerances for thickness. In other words, he knows in advance very specifically just what he is looking for and is prepared to deal with these defects if they occur.

The auditor, on the other hand, is exploring an unknown area of defects. He will not know their nature until he finds them, at which time he will evaluate their importance. He does not have a set of specifications and tolerances similar to that of the purchaser of materials. He must find and appraise. This difference renders of limited value to the auditor the straightforward use of acceptance sampling tables to reject lots with more than a certain per cent defective.

The purchaser of material can place a dollar cost on the occurrence of a defective item in the materials he buys by estimating the cost of interruption of his

manufacturing process, reworking, scrap and other similar factors arising when a defective part finds its way into the production line. He can calculate the cost of inspection as well as the cost of ordering materials with closer tolerances, and contrast these costs with the cost of not finding a defective item in his raw material. He can then strike a balance between these costs and fix, with a fair degree of precision, the per cent defective which he can economically permit to pass and that which he must attempt to reject on the basis of this economic consideration.

The auditor cannot and should not be required to attempt to fix a per cent of error above which he will "reject" and below which he will "accept", especially since he cannot evaluate the nature of the errors or their impact until he finds them and seeks out their cause. On the other hand, the auditor does have a general idea (though not precise) of a level of error which would be intolerable.

It is true that in some rare instances a fairly high tolerable level of occurrence of error can be permitted, as in a multitude of small transactions, if only their impact on the total dollar value is considered, but it is doubted that an auditor would rest easy with such evidence of sloppy bookkeeping even if the total dollar error is small. It is not to be implied that the auditor should expect no errors. They will be found as long as humans are involved and even when machines do the work. But the actual fixing by an auditor of a given precise per cent of error as the maximum is generally another matter.

On the other hand, it is not to be implied that the acceptance sampling approach is never useful. Actually, it may afford the best method in certain situations but this approach must be used with care in those situations for which

it is best suited. For instance, internal auditors will find it particularly useful in certain types of investigation while accounting departments will find wide application for it in the control of clerical errors. At a later point, a modified use for acceptance sampling in independent audits will be proposed. It is merely suggested that it is not the easy way out that some suggest.

Estimation Sampling

The approach to the problem through the use of estimation sampling attempts an estimate of the frequency of occurrence of disparities within any desired degree of accuracy, or of the total magnitude of such errors. Only the question of estimating the relative frequency of error will be discussed here. Once again it is necessary that probability sampling methods be used.

If the sample has been drawn at random, tables such as those shown in this article may be used to determine the sample size required to achieve the desired degree of accuracy. Suppose, for instance, that the auditor wished to determine the relative frequency of occurrence of departures from some aspect of the internal control system and that he decides that he will be satisfied if he can estimate this occurrence to within 2% of the true but unknown occurrence of error in the 4,000 documents to be tested. Resorting to the appropriate line in Table II (page 466) for the proper field size (4,000) he will find the appropriate sample size (711) under the column headed 2%.

But what about the sampling risk involved? This risk is expressed as the confidence level. A 95% confidence level, such as that designated for Table II, means that there are 95 chances out of 100 that his estimate will not exceed the 2% desired, while most likely it will

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be less. Perhaps this risk is too large. In that case, a second table with a 99% confidence level may be used. Such a table will provide sample sizes such that there is only 1 chance in 100 that due to the vagaries of sampling the desired $\pm 2\%$ will be exceeded. Of course, tables with other confidence levels may be compiled.

It is to be noted that Table II is to be used only if the error rate is not expected to exceed 10%. If the error rate may be reasonably expected to be less than 5%, other tables may be used. The use of these alternative tables will result in lower sample sizes. Other tables are possible with even lower sample sizes if the expected error rate

Table II

TABLE OF SAMPLE SIZES REQUIRED FOR SPECIFIED CONFIDENCE LEVELS
AND RELIABILITY LIMITS FOR SAMPLING ATTRIBUTES
IN FINITE POPULATIONS

FOR RANDOM SAMPLES ONLY

95% Confidence Level

Number of Items In Field	Sample Size for Reliability of:					
	1%	2%	3%	4%	5%	10%
500			217	151	108	32
1,000		464	277	178	121	33
1,500		548	306	189	127	34
2,000		603	322	195	129	34
2,500		642	333	199	131	34
3,000		671	340	201	132	34
3,500	1739	693	346	203	133	34
4,000	1854	711	350	205	134	34
4,500	1955	725	354	206	134	34
5,000	2044	737	357	207	135	34
6,000	2193	755	361	208	135	34
7,000	2314	769	364	210	136	34
8,000	2413	780	366	210	136	34
9,000	2497	788	368	211	136	34
10,000	2568	795	370	211	136	34
15,000	2809	817	374	213	137	34
20,000	2947	828	377	214	137	35
25,000	3036	835	378	214	137	35
50,000	3233	849	381	215	138	35
100,000	3341	857	383	216	138	35

To be used only where expected error does not exceed 10%.

is still lower, say less than 2%. The only result of using a table where the error rate is greater than that specified is less accuracy of estimate than originally desired, a fact which can be established after sampling. It is important to note that Table II and others based upon varying percentages of confidence or expected error are not the usual tables found in statistical and quality control texts. These tables are especially designed to meet the needs of the auditor.

Through the use of appraisal or estimation sampling, the auditor may make an estimate of the extent of existing disparity with any degree of accuracy required and with any specified sampling risk. It is to be noticed that this method does not require the auditor to make an advance decision as to the maximum permissible error frequency. On the other hand, it does not provide him with an automatic accept or reject decision. He must then evaluate his results in terms of his other findings. After the sampling has been completed, reference to other tables will enable the auditor to determine the actual accuracy achieved, which may be more or less than that desired. These additional tables are not included in this article but can be compiled.

A Compromise Method

Yet there are those who feel that the acceptance sampling approach is simpler, especially where the sampling must be delegated to juniors. A compromise approach may be suggested for those who wish to obtain this advantage—an approach which will overcome some of the disadvantages of the acceptance sampling method. This method would require the auditor to establish a severe criterion of maximum permissible frequency of error, more severe than would be used for ordinary accept-

ance sampling. If the sampling plan calls for rejection, the auditor would then switch to the estimation sampling method to determine the actual level of frequency of error. If additional sample items are required, the items selected at random for the acceptance sampling approach may be combined with additional items selected at random for this purpose.

Like most compromises, this approach retains some of the advantages and disadvantages of both methods. From a statistician's viewpoint, this must be looked upon with partial disfavor, but it may commend itself nevertheless to some auditors as appropriate to their problem.

A different situation confronts the auditor when he wishes to estimate, by sampling, the dollar magnitude of errors, or the dollar magnitude of some figure. Here the use of estimation sampling will provide an estimate of dollar magnitudes with any desired degree of accuracy, to within \$1 if desired. This type of sampling plan also may be developed through resort to tables.

Discovery Sampling

An entirely different situation may confront the auditor under other circumstances. The test may be directed at locating examples of certain types of serious disparities, failures to adhere to internal control requirements or evidences of manipulations or fraud. This method is called *discovery sampling*.

By resort to random sampling and the use of appropriate tables such as Table III (page 468), it is possible to secure any desired degree of assurance of finding at least one example of the type of disparity in question, if it occurs with a certain minimum frequency. The table indicates the sample size to be used to achieve a given degree of

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assurance of finding at least one such example of the error sought. For instance, if a certain type of disparity occurs in a field of 2,000 entries only in 0.5% of the entries, or only 10 times, a sample of 600, randomly chosen will provide a 97.2% probability of un-

covering at least one such disparity in the sample.

Since the disclosure of at least one such disparity in the sample may occur at any point in the sampling, the sampling may be terminated at that point if so desired and an appropriate investi-

Table III

TABLE OF PROBABILITIES OF INCLUDING AT LEAST ONE ERROR IN A SAMPLE OF A GIVEN SIZE WHEN FIELD INCLUDES SPECIFIED PER CENT OF ERROR FOR RANDOM SAMPLES ONLY

When Sample Size is:	When Fraction Defective Is:					
	.1%	.5%	1%	2%	5%	10%
Probability of finding at least one defective is:						
Field Size is 200						
10			9.8%	18.7%	40.9%	66.0%
25			23.5	41.6	74.6	94.0
40			36.1	59.4	89.9	99.1
50			43.8	68.7	94.8	100.0
60			51.1	76.3	97.4	100.0
80			64.1	87.3	99.5	100.0
Field Size is 500						
10		5.9%	9.6%	18.4%	40.4%	65.5%
25		14.3	22.7	40.4	73.2	93.3
50		27.1	41.1	65.5	93.3	99.6
75		38.7	55.8	81.1	98.5	100.0
100		48.9	67.4	89.5	99.7	100.0
200		78.5	92.3	99.4	100.0	100.0
Field Size is 1000						
10		4.9%	9.6%	18.4%	40.3%	65.3%
25		11.9	22.5	40.0	72.7	93.1
50		22.7	40.3	64.5	92.8	99.6
100		41.0	65.3	88.1	99.6	100.0
200		67.3	89.4	98.9	100.0	100.0
400		92.3	99.4	100.0	100.0	100.0
Field Size is 2000						
10	1.0%	4.9%	9.6%	18.3%	40.2%	65.2%
50	4.9	22.4	39.9	64.0	92.6	99.5
100	9.8	40.2	64.3	87.4	99.5	100.0
200	19.0	65.2	88.0	98.6	100.0	100.0
400	36.0	89.3	98.9	100.0	100.0	100.0
600	51.0	97.2	99.9	100.0	100.0	100.0

gation undertaken. Actually the sample sizes indicated are maximum sizes. If the sampling is continued to the maximum sample size without disclosing a disparity, it may be interpreted to mean that there is a high probability (97.2 chances in 100) that either there are no such disparities or that they occur with less than the indicated frequency (0.5%). This specialized type of sampling may well have many uses as part of the auditor's examination.

Preparation of the Profession

How then can we prepare the profession for the use of these new tools? As previously emphasized, it is not necessary to attempt to make statisticians out of the auditors nor should it be necessary to take a statistician along for every examination. Neither of these two situations is required. Appropriate tables can be provided to the auditor to cover every situation. Many of these tables still remain to be computed. However, a certain understanding of the principles is necessary to the best use of these tools. The enlargement of the literature on this subject which is now taking place together with the on-the-job training provided by many auditing firms will provide this understanding among the working auditors.

The young college graduate entering the field will generally come equipped with at least one required course in statistics as part of his academic equipment. Unfortunately, these courses while providing some knowledge of statistical principles frequently have touched only lightly upon the whole subject of sampling. Since the future of the accounting profession will rest upon the shoulders of these newcomers,

it is necessary that they be given specific training in sampling problems in auditing. The various accounting societies as well as the individual accounting firms can play an important part in urging upon the various colleges and universities that such a course be required of all undergraduate accounting majors.

It will become necessary for the statisticians to develop a greater interest in this subject. It is from them that guidance will be obtained. Evidence of an increasing interest in the subject may be seen in their literature. The American Society for Quality Control has scheduled a meeting for the Fall of 1957 to discuss the various aspects of the problem from the statistician's viewpoint.

It is felt that we can look forward to a rapid development of the use of this new tool by the auditor, since the use of objective methods of sampling and sample evaluation will provide many advantages while providing a completely defensible test method, but it will by no means replace his judgment. These methods merely represent a new tool which is available to the auditor by means of which he can assure himself that the data he cumulates truly represent the state of the records. The methods are tools which aid the auditor. They do not represent any magic formula or "push button" mechanical method which will remove the responsibility of interpreting the results of the tests from his shoulders. If anything these methods will require the exercise of a higher order of judgment and as a result will provide greater confidence in the reliability of these judgments.

Demolition and Involuntary Conversion

By STANLEY B. GREY, C.P.A.

This article presents a summary view of the treatment accorded taxpayers in cases involving demolition and involuntary conversions, and suggests some of the related problems under the 1954 Internal Revenue Code.

Demolition

The regulations provide, in effect, that the deductibility of a loss upon the demolition of a building depends on the intent of the purchaser at the time of the acquisition of the property.¹ Where the taxpayer acquires the property with a view to razing the old structures, to erect a new building, the regulations state that the taxpayer will be considered to have suffered no deductible loss. The Internal Revenue Service's position is that the value of the land acquired is equal to the purchase price of the land and building plus the cost of removing the building.

Application of the Rules

Let us apply these rules to the various situations that may occur:

1. The property was acquired with no intent to demolish; property is subse-

quently demolished but no new building is erected.

Under the circumstances outlined above, the regulations would allow the taxpayer a deductible loss on demolition in the amount of the unrecovered basis of the building. The cost of demolishing the structure would also be deductible. This situation seems to be the only one in which an allowable loss will be incurred.

2. The building, which was acquired with no intent to demolish, is demolished and a new structure is erected.

The Commissioner, backed by the courts,² has been denying deductible losses to taxpayers in these circumstances. He has been requiring them to capitalize these losses to the cost of the new buildings. The theory behind such treatment is that the mere destruction of the old structure is an open transaction, therefore no loss is recognized; the transaction is closed when the new building is completed.

3. The taxpayer intends to demolish the buildings and sometime in the future build a new structure.

This situation would seem to fall under the language of the regulations³ and the loss would not be deductible; instead it would be treated as additional land costs.

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This article has been adapted by the author from a paper presented by him at the December 17, 1956 technical meeting sponsored jointly by the Society's Committees on Federal Taxation and on Real Estate Accounting.

4. The property is acquired with the intent to demolish and erect a new building. The property is destroyed and the new structure erected.

This set of facts, as in example (3) above, falls under the situation specifically covered in the regulations and therefore the loss on demolition would be treated as an additional land cost.

Authorities Differ

Some authorities contend that regardless of the purchaser's intent, the demolition losses should be added to the cost of the new structure, rather than the land. Their position is seemingly sustained in a number of court cases.⁴

To compute the loss, an allocation of the purchase price between land and building would have to be made. The Commissioner contends that at the time of acquisition, because of the intention to demolish, the buildings had no value—and we are right back where we started.

Salvage Operation

Where such property is temporarily used as a rental operation prior to its demolition, the Internal Revenue Service has been denying taxpayers depreciation deductions on the structures on the theory that the total price paid was for land; the buildings have no value. An interesting argument might be made, that the rent collected, and the expenses of operating the property, merely constitute an adjustment in the cost of the land. In effect, under the open transaction concept, the temporary rental business is merely a salvage operation, and the "loss" or "profit" therefrom is additional land cost or salvage proceeds (reducing the cost of the land) as the case may be.

Involuntary Conversion

An involuntary conversion of property occurs when property is compulsorily or involuntarily converted into money or other property as a result of its destruction (in whole or in part), its theft, its seizure, its condemnation through eminent domain, or its sale or other disposition due to the threat or imminence of requisition or condemnation.⁵ The latter provision requires that the threat or pressure be from legal sources rather than from merely moral or economic sources. For example, where the sale of property was made because the local Chamber of Commerce applied pressure on the taxpayer, the court held that the involuntary conversion section did not apply.⁶

Treated as a Sale

For all intents and purposes, the Code treats involuntary conversions like sales. If the converted property was a capital asset, or property used in trade or business (Section 1231), the taxpayer realizes a capital gain or loss; if the property converted is inventory in the hands of the taxpayer, any gain or loss will be treated as ordinary income or loss. Because of the involuntary nature of the transaction, the Code permits the taxpayer to postpone the recognition of gain on the conversion by replacing the lost property with property similar or related in service or use.

Related Property

Even though the terminology of Section 1033 describing replacement property (similar or related in service or use) is much narrower than that contained in Section 1031, dealing with tax-free exchanges, the property acquired as a replacement need not be an exact duplication of the converted

Demolition and Involuntary Conversion

property. The Tax Court has held⁷ that the section is a relief provision and as such should be construed liberally. The Commissioner, however, has won cases on some very "unliberal" interpretations of the section.⁸ And the Commissioner's attitude has not changed. In a recent Revenue Ruling⁹ it was held that a corporation, which had rented property to a tenant for the conduct of a garage business, did not have a tax-free replacement of this property under Section 1033 when it acquired other rental property which it leased to various retail stores. The Treasury Department said that merely replacing *rental property* with *rental property* wasn't sufficient; the functional use test must also be met. This is another indication of the Treasury's interpretation of the phrase "similar or related in service or use."

Some examples of what may be considered similar or related property are as follows:

1. Replace converted apartment house with an apartment house, or two apartment houses.
2. Undivided interests in the same parcel of property.
3. Replace converted farm land used for raising livestock and growing fruit, with farm land used for growing crops.
4. Replace vacant land with vacant land.

Some examples of what would be considered unrelated property, not qualifying under Section 1033, are as follows:

1. Replace vacant land with improved realty.
2. Replace tugboats with barges.
3. Replace commercial rental property with safe deposit boxes.¹⁰

Replacement Requirements

The replacement may be made by acquiring control of a corporation owning such similar or related property. Control in this instance means ownership of at least 80% of all the classes of stock outstanding. However, investment of the funds in a partnership owning such similar or related property does not constitute a replacement within this section. The replacement must be made by purchase. A replacement by gift, or tax-free exchange will not qualify under Section 1033. It should also be noted that while the gain on an involuntary conversion may be postponed, losses are always recognized.

Computation of Gain

Gain is recognized to the extent that the amount realized on the conversion exceeds the cost of the replacement property. The amount realized is reduced by expenses incurred in connection with the conversion.

Example: Taxpayer has property with a \$50,000 basis; he receives \$80,000 in condemnation, incurring expenses of \$2,000 in connection therewith. He purchases similar property for \$70,000 within the prescribed time. There is a recognized gain of \$8,000 on the replacement. The basis of the new property is \$50,000 (the \$70,000 cost less the \$20,000 of unrecognized gain).

Mortgage Indebtedness

In computing the amount realized as proceeds on the conversion, indebtedness on the converted property such as a mortgage, must be included. Similarly, the cost of the replacement property includes any mortgages or other indebtedness which the taxpayer assumes or takes subject to, on the purchase.

Example: Taxpayer owns an apartment house whose adjusted basis is

\$100,000 and on which there is an outstanding mortgage of \$60,000. The property is condemned for \$150,000, the condemning authority paying \$60,000 to the mortgagee and \$90,000 to the taxpayer. The total realized in condemnation is \$150,000.

If the taxpayer acquires similar property within the requisite time for \$150,000 with \$50,000 cash and a \$100,000 mortgage, he has satisfied the requirements of the section and is ahead cash-wise. The basis of the replacement property remains the same as the basis of the converted property.

Replacement Period

The Code provides that the replacement period begins with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property. The period ends one year after the close of the first taxable year in which any part of the gain upon conversion is realized. In other words, for a calendar year taxpayer, if the condemnation award is received in June, 1957 the replacement period would end December 31, 1958. The Commissioner may grant an extension of the replacement period upon application.

Election

The taxpayer makes his election not to report the gain on an involuntary conversion by excluding the gain from gross income in the return filed for the year it is realized. If, after the election is made, the taxpayer decides not to replace the property or to replace it at a lower cost, an amended return must be filed. If the taxpayer included the gain in his gross income in the year of realization, and within the allowable time makes the requisite replacement, the election may then be made by filing a claim for refund.

Section 337

An interesting problem concerning involuntary conversions has arisen under Section 337 of the Code (dealing with 12-month liquidations). The question is whether an involuntary conversion will qualify as a sale within the purview of Section 337. The Treasury Department stated in a recent Revenue Ruling¹¹ that a conversion caused by fire will not qualify as a sale for purposes of Section 337. This leaves still unanswered the question of how a disposition through condemnation would be treated. However, the American Bar Association indicated recently¹² that the Treasury Department will issue a ruling stating that a governmental body's condemnation of a corporation's sole asset does constitute a sale of that asset in a Section 337 liquidation.

References

1. Reg. Section 1.165-1(b).
2. *Biscow v. United States*, 139 F. Supp. 775; *Acacia Mutual Life Insurance Co.*, BTA Memo Op., Dec. 8621-B.
3. Reg. Section 1.165-1(b).
4. *Com. v. Estate of Appleby*, 123 F (2d) 700; *McCarthy*, T. C. Memo, 5-22-43; *Phipps Estate*, 5TC964.
5. See Internal Revenue Code Section 1033 (a) (1).
6. *The Davis Co. v. Commissioner*, 6BTA 281.
7. *Massillon-Cleveland-Akron Sign Co. v. Commissioner*, 15 TC 79, (acquiesced).
8. *Lynchburg Nat. Bank*, 20 TC 670, aff'd. 208 F (2d) 757 (4th Cir. 1954); *Winter Realty*, 2 TC 38.
9. Rev. Rul. 56-347, IRB 1956-30, 16.
10. See (8) Supra.
11. Rev. Rul. 56-372, IRB 1956-32, 34.
12. 6 Jour. of Taxation 261 (1957).

Insolvency and Bankruptcy Procedures of the New York State Tax Department

By JACOB LEINWANDER

State tax procedures in the administration of corporations undergoing reorganization or liquidation under the Federal Bankruptcy Act or under the debtor and creditor laws of the State of New York.

This article will provide a brief outline of the tax procedure in insolvency matters as followed by the Bankruptcy Unit of the Corporation Tax Bureau of the New York State Department of Taxation and Finance.

In New York State all domestic corporations and foreign corporations doing business in the State of New York, are subject to franchise taxes under appropriate Sections of Articles 9 and 9A of the Tax Law.

JACOB LEINWANDER is Supervisor of the Bankruptcy Unit, Corporation Tax Bureau, Department of Taxation and Finance, State of New York. He has been employed in the Corporation Tax Bureau since 1927 and has been Supervisor of the Bankruptcy Unit since 1945. He has aided materially in developing the procedures of the Bankruptcy Section.

This article has been adapted from a paper presented by the author at the October 8, 1956 technical meeting of the Society held under the auspices of the Committee on Insolvency and Bankruptcy Procedures.

The primary responsibility for determining the franchise taxes due the State by corporations involved in insolvency proceedings is delegated to the Bankruptcy Unit of the Corporation Tax Bureau. The Albany office, where all our tax claims must be processed, files the necessary claims on recommendation from the New York office. In certain cases, however, the New York office has the authority, in conjunction with the Attorney General, to file claims on stipulation of consent or on motion to the court.

Types of Proceedings

The various types of proceedings which this Unit investigates are:

1. Bankruptcies, which include all corporate proceedings filed in any United States District Court under the Federal Bankruptcy Act such as: Chapter III Bankruptcies, Chapter X Re-organization Proceedings, and Chapter XI Arrangement Proceedings.
2. All other State judicial proceedings such as: General Assignments for Benefit of Creditors under the debtor-creditor laws of this State.

3. Various types of Receiverships such as: Mortgage foreclosures, Condemnations, equity receiverships, Martin Act Receiverships and any other legal proceedings of a similar sort.

4. Miscellaneous matters such as: Bulk Sales under Section 44, Personal Property Law, Common Law Deeds of Trust (unrecorded), Settlement with Creditors through trade or credit associations or committees, and any and all proceedings in the nature of liquidations.

All judicial proceedings and miscellaneous matters as stated above are handled from the New York office, if they occur in any county of New York State below Rensselaer County on the east side of the Hudson River, and all counties below Albany County on the west side of the Hudson River. Most of our Federal Proceedings arise in the Southern District and Eastern District Courts but may be instituted in any District Court of the United States.

Statutory Basis for Claim

All tax claims are filed in the name of, The People of The State of New York, The State Tax Commission, and the Attorney General of the State of New York as attorney for Claimant. There are two types of claims, liquidated and unliquidated, in which the State claims priority and a statutory lien for franchise taxes under Section 197 and/or Section 213 of Articles 9 and 9A of the Tax Law respectively. These claims provide that each such tax, until the same is paid in full, "shall be a lien and binding upon the real and personal property" of the corporation. In bankruptcy proceedings, in addition to the above, the State claims a priority under Section 64, Subdivision a, of the Bankruptcy Act, (being Section 104, Title XI U.S. Code, Annotated), and claims a statutory lien pursuant to Section 67, Subdivision b, of the Bank-

ruptcy Act, and payment thereof is demanded in accordance with the provisions of Section 67, Subdivision c, of the Bankruptcy Act, (being Section 107, Title XI, U.S. Code, Annotated).

Sources of Insolvency Advice

In order to adequately prepare for a matter, and before official notices are received by the Bankruptcy Unit of these Judicial proceedings, an employee of the New York office makes frequent calls at the United States District Court, Southern and Eastern Districts of New York and at the New York and Kings County Clerk's offices, and obtains the names of the Corporations so involved from the Dockets, with other necessary and pertinent data. The other County Clerks notify the Department by mail of any general assignments. The non-judicial and miscellaneous matters are obtained from trade publications, notices, etc. This information is forwarded as soon as feasible to our Albany office where the corporation file is processed. The Albany office immediately prepares and files claims with the proper parties as indicated from the data submitted to them.

Filing of Claims

An unliquidated claim is immediately filed in all cases, that is a claim in an undetermined amount, from the date of the last tax period filed to termination of proceedings, and also, for purposes of possible re-audit, for five prior tax periods under Section 195 and/or Section 212 of Articles 9 and 9A of the Tax Law respectively. If there are any unpaid and outstanding taxes due, a liquidated claim is also filed setting forth among other things the tax periods and the amount of tax due. The originals of these claims are filed with the proper party, depending on the type of proceeding, and copies are forwarded to various interested parties.

Procedures Undertaken by Tax Examiner

Necessary records are made upon receipt of a case at the New York office from our Albany office. When received, the file is usually complete and contains a record of the Corporation and copy or copies of claims filed. Within the next day or two, assignment of the case is made to a Tax Examiner in accordance with his ability and the type of case. The Tax Examiner goes to work on the case immediately.

The usual procedure is to send a letter to the interested parties, informing them of the franchise tax claims filed, requesting certain information and advising them of the requirements necessary to withdraw or liquidate the unliquidated claim. The Tax Examiner from thereon follows up the case depending on the type of proceeding, the information desired and the amount involved. In most cases, this entails field work. The Tax Examiner is unable to make a field audit in all cases. A field audit therefore is generally required of those Corporations which are not permitted by the courts to engage accountants to prepare tax reports, and for non-court cases where the estate does not permit the hiring of accountants.

Upon receiving the tax reports and auditing same, or making field audits and obtaining the pertinent data, the Tax Examiner sends same to our Albany office with his findings and recommendations on technical questions, tax assessments and filing of claims. If they are found to be in order, the Albany office then makes the assessments and files a liquidated claim to replace the unliquidated claim in the proceedings. However, before this is accomplished the Tax Examiner must obtain verification and explanations of all questionable items, results of Federal audits and changes, and information as to the progress of the proceedings, etc. This

entails correspondence, telephone calls, examining books and records of the corporation and court records, preliminary hearings with corporation's representatives, conferences, attending court hearings with a representative of the Attorney General's office and whatever else may be required.

The Tax Examiner at times is often called upon to make audits of incomplete books and records. The former accountants of the debtor corporation can be very helpful and usually are, as their file contains useful information to assist the Tax Examiner to arrive at a tax assessment.

Avoidance of Tentative Assessments

It has been the policy of the New York office to avoid any tentative or estimated tax assessments wherever possible. This requires the assistance and co-operation of the accountants and attorneys interested in the proceeding. This may appear to be annoying or unnecessary at times but since time is of the essence and deadlines must be met in these matters, it will save time by avoiding last minute adjournments and applications to correct our estimated tax claim or to liquidate same. Our New York office has always co-operated with all concerned by granting conferences or hearings to avoid estimated or tentative assessments which are recommended only when all other means have been exhausted. After an assessment is made, it is rather difficult to recommend a change, because such change puts the burden of proof on the accountant and attorney, and means more work and expenditure of time for them.

Installment Payments

It is necessary at times to enter into a stipulation providing for the payment of the Franchise Tax Claim on an in-

stallment basis in a Chapter X or XI proceeding. This is avoided whenever possible as it entails additional records and follow-up. It is acceptable only if the total payment causes an undue hardship on the Debtor Corporation, and the method of payment is agreeable to the other taxing agencies. This proceeding may be obtained by a stipulation by consent through the New York office which requires the approval of the Attorney General as well as the Tax Commissioner.

Final Accounting

After the final liquidated claims are filed, the State Tax Department usually receives a notice of final accounting. Upon receipt of such notice, the Tax Examiner or a representative of the Attorney General's office verifies the listing of the Franchise Tax Claim, and is apprised of the amount of the estate, administrative expenses, requested fees and all priority claims, and is usually informed as to whether our claim is to be paid in full, in part or not at all. The case is then ready to be closed. The Tax

Examiner writes a detailed report of investigation and makes any necessary recommendations. The complete file is returned to the Albany office with any additional material considered pertinent to the file, together with the Tax Examiner's report of investigation after it has been reviewed and approved by his superior. A copy of the report of investigation and certain records and work sheets remain at the New York office for future availability. The New York office also maintains inventory and case records and a daily calendar of notices, meetings and hearings and refers cases to the Special Investigations Bureau if the facts warrant same.

The New York office attends hearings on all motions to expunge or liquidate claims and the Tax Examiner acts as a technical and expert witness. The New York office moreover is available to answer a host of questions involving the tax law and procedure whenever a point of same is in doubt or the party requesting same desires guidance or information.

Information for the CPA Candidate

If we view the CPA candidate as one who is seeking recognition by an established professional group, it seems basic that the candidate should expect to be called upon to demonstrate that he is well acquainted with the stand taken by the profession, through its organization the American Institute of Accountants, on matters of interest to the profession relating to the practice of public accountancy. To be more specific, a candidate should know the recommendations made, or the conclusions reached, by the several committees of the American Institute of Accountants. Certainly this would require rather detailed familiarity with bulletins of the Committee on Accounting Procedure and the Committee on Auditing Procedure. Also, a candidate should know the "Rules of Professional Conduct." And every accountant, whether or not a candidate, will profit by reading, regularly, the well-known periodicals of the profession. This seems particularly relevant for the candidate, for he should without question be acquainted with and able to discuss accounting controversies.

from INFORMATION FOR CPA CANDIDATES, the American Institute of Certified Public Accountants, 1954.

Office Automation and Auditing Techniques

By ALLAN T. STEELE, C.P.A.

The introduction and increasing acceptance of electronic data-processing systems has created widespread inquiry as to the extent to which traditional auditing techniques and accounting controls will require modification. This article considers the basic issues and suggests certain alterations in the auditor's approach.

The title of this article might perhaps better be stated as a question, "Will Office Automation Change Auditing Techniques?" No positive answer can be given to this question at this time, since office automation is still in its early development stages. All indications, however, point to the conclusion that the auditor's position will be improved. He will find himself examining records produced under the best of internal control safeguards and will thus be able to satisfy himself as to their reliability with a minimum of test-checking. Under such conditions, the auditor will be able to devote more of his efforts to a higher level of investigative work in connection

with the forming of an opinion as to the reliability of the records and statements under examination.

Traditional Procedures Largely Unaffected

Since electronic data-processing equipment will, at least for the present, be employed only for those parts of the accounting system which involve large volumes of similar entries, a great part of the auditor's work will remain in much the same form as before. Automation will relieve the auditor of certain routine portions of his former work, but he will still find it necessary to reconcile and confirm cash balances, confirm receivables, observe inventory-taking, etc. It would appear then that only a portion of the auditor's work will be affected by the introduction of electronic machines. In connection with this part of his work, it will only be necessary for him to change his approach and alter his audit procedures as required to meet the new accounting methods.

The Audit Trail

Under the old pen-and-ink methods, the "audit trail," consisting of source documents (invoices, vouchers, etc.), journal entries, and ledger accounts posted in detail, was available for the

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This article has been adapted by Professor Steele from a paper presented by him at an N.A.C.A. meeting held on February 21, 1957 in Shreveport, Louisiana.

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auditor's use. At every point along the trail, his path was carefully "blazed" for him with posting references and similar cross-reference markings.

With the advent of posting machines, and more recently the use of punched-card accounting machines, the auditor sometimes found this audit trail confused by the use of summary totals in ledger accounts instead of the former complete detail, or by the substitution of batches of punched cards for visible written records. This seeming obscuration of portions of the trail was always more than offset by the improved internal control which was developed along with the machines. When a new machine was installed by a company, new control methods were devised as a means of proving the accuracy of machine postings. Independently prepared pre-list tapes and control accounts developed outside of the machine accounting section were used to prove the accuracy of the machine accountant's work. These control measures, created by the company's own accounting staff for their own protection, were then available to the auditor. They served to reduce the amount of the auditor's detailed checking, since he was able to rely on these internal controls as a basis for reducing test-checking activities to a minimum.

With the advent of electronic data processing machines, the original source document and the final trial balance (in the form of a tabulated-run statement) were the only remainders of the former audit trail. In between lay a maze of punched tape, punched cards, magnetic tapes, magnetic drums, and all the other equally puzzling parts of an electronic data-processing system.

New Control Measures

When the auditor recovered from his first sense of distress, he usually found

that the company's machine accountants, being equally concerned about losing control of this "robot-gadget," had set up the same sort of independent control measures that they had previously used under other accounting systems. In fact, they probably had improved upon previous methods in this area of internal check and control. The same sort of pre-list tapes and control ledgers or accounts are being used in connection with the electronic machines as were previously used with other types of equipment. Internal control is usually the auditor's first field of investigation, particularly in a new engagement. Before he can determine how far he must go in his other activities, he must familiarize himself with the control methods being used in the various parts of the system, and he must satisfy himself that they are being carefully followed through as planned. The only thing new about this activity on the part of the auditor is that he is working with a new kind of equipment and with correspondingly new control procedures.

Basic Safeguards

The typical electronic system is composed of an input system, a computer, storage units, and an output system. In many instances, the old familiar punched cards are involved in some stage of the process, and the auditor is fast discovering that punched tapes, magnetic tapes, and magnetic drums are just as permanent and safe a medium for carrying out accounting entries as are punched cards. Also, in most if not all of the present systems, the original source documents are being preserved for a period of time. They are therefore available as a means of reconstructing information which may be lost through the destruction of a card or a punched tape, the accidental erasure of a magnetic tape, or damage to a mag-

netic drum. With this safeguard to fall back on, the auditor can turn away from his fears on this point and devote himself to the test-checking of the various portions of the electronic accounting system.

Input Stage

Many machine accountants seem to feel that control of the input stage of the operation is the most important factor in insuring accuracy of the work. In fact, this is the point on which most of the control procedures seem to be centered. Control at this point may be facilitated by the use of one of the machines which produces a five-digit paper tape and at the same time prints an adding machine tape which may be compared with a previously run regular adding machine tape. The punched tape then becomes the basis of the introduction of data into the computer.

In other instances, where punched cards are being used as the basis of introduction of data, the accuracy of the punching of these cards may be verified through the use of the usual punched-card verifier in which the same material is punched twice by different operators and the cards automatically compared as they go through the second punching operation. The auditor's first step in this phase of the operation should be to familiarize himself with the control measures used and to see that these control measures are being carried out as planned. A reasonable amount of test-checking of the results of these operations in the period under review, plus some observation of the work being currently carried on in the client's office, should satisfy the auditor as to the reliability of the input operation.

Computing and Storage Stages

In the computing and storage stages of the electronic process, the auditor loses any visible audit trail, and it is probably in this phase of his work that he becomes most concerned about the reliability of the machine work. The operation of the electronic computer is controlled automatically through the use of a program. Barring deliberate manipulation of the control console by the operator or failure within the machine itself, the results will be as planned, with a degree of accuracy far surpassing that achieved by human operators. The auditor's task then, it would appear, is to find ways of detecting any such manipulation of the machine or unintentional machine failures. His first step should probably be to determine the nature and the aim of the program being used in any given case. He could then observe the operations of a test run to determine that the equipment is performing as programmed.

It has been suggested that the auditor might avoid requesting special test runs of this expensive equipment by inserting into a regular operating run several fictitious items on which the required answers had already been computed by other means. If the results of the electronic computation agree with those otherwise calculated, it should be safe to assume that the computer is functioning as planned.

With regard to malfunctions of the equipment, the electronic machines (like punched-card equipment) when difficulties arise will usually produce figures of such unusual size that the mistake will be immediately apparent to the operator. In most installations at present, there is the additional protection of having control ledgers or accounts prepared

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either in the machine accounting section or as an independent outside activity. These control ledgers are built up from the daily computer runs to produce monthly totals against which the final results of the month's operations may be proved. Here again is a control feature which the machine accountants have worked out for their own protection and which can be of tremendous help to the auditor.

If the program investigations mentioned previously did not reveal errors (intentional or otherwise), the end-of-the-month balancing against these controls should uncover any such variations from the correct results. With regard to that part of the information which is stored in magnetic drums or tapes, the insertion of fictitious transactions into the operation as a check on the programming should also serve as a check on much of the stored information. If it seems necessary or advisable, the auditor can request a special run of the machines to convert the stored data into visible form which could then be verified by other normal auditing procedures as dictated by the nature of the data in question.

Output Operation

The output operation of many systems now in use is carried out through the use of punched cards which have previously been produced by the computing equipment. These cards are sorted and used to produce tabulated runs of whatever type of information is desired. The use of these procedures gives a great deal of flexibility in adapting this final stage of the system to produce desired results. The auditing of this portion of the system may be based upon a comparison of final run totals with the proof or control totals which have been accumulated

independently. Since this is the final step in the electronic trail which the auditor has been following, he can now select a sample of items from the run statements and check them back to the original source documents. If it seems desirable, the auditor can select a set of original data which should tie in with certain figures on the final runs and carry out the computations manually to determine the accuracy of the results as shown on the tabulated runs.

For instance, if the problem were one of working from a set of meter readings on a gas well to the final runs showing royalty and other interest payments to be made on the production from this well, he could select the meter charts for a specific location and make the necessary calculations to arrive at the final net production figures in terms of both physical quantities and dollar values. The amounts arrived at by this independent calculation should agree with those produced on the electronic computer. If a sample of such items shows a high degree of accuracy, the auditor may be satisfied that the work is being performed accurately even though a portion of the audit trail rests in the electronic equipment.

Effect of Further Input Mechanization

One possible future development which may cause the auditor some difficulty is the further mechanization of the input function. This phase of the operation could conceivably be carried to the point of recording directly from the original media into a magnetic tape or drum without the production of any conventional visible records. Should this come to pass, the auditor would then have to find other ways of verifying the accuracy of the input process. The answer to such a problem is diffi-

cult to determine at the moment. One thing is certain though, the machine accountants will never accept any such input procedure unless there are means available for verifying their own work. This proof activity is for their own protection, but in turn it will undoubtedly serve as a means of aiding the auditor in accomplishing his work.

Consultation With CPA In Early Planning Stage

The changes in auditing techniques to meet the adoption of electronic systems will consist of developing new ways of coping with the new systems. As has previously been indicated, records prepared on this type of equipment are just as capable of being audited as are those prepared on other types of equipment. The electronic machines are simply a

means of performing the computing and recording functions, and the auditor will find ways to verify the accuracy and authenticity of these records just as the machine accountants have been able to devise control methods to prove the accuracy of their work.

The independent public accountant, in the interest of facilitating the carrying out of his audit program and as a service to his client, should seek the opportunity for consultation in devising adequate control measures. Such service would be most effective if rendered during the early planning and installation stage with close follow-up review after the system has begun to operate. This review by the independent accountant, as previously discussed, will constitute an essential feature of his audit functions.

Accounting in Colonial America

As trade was so largely based on book-keeping barter, many people (including petty shopkeepers and farmers) had to keep accounts. What sort of system did they use?

The answer is clear. Everyone in business had some inkling of standard double entry, and took its form as his model; but remarkably few seem to have had the skill—or felt the need—to push the system to anywhere near its full perfection. Crude single entry was overwhelmingly the rule. I have not come across any colonial ledger that is certainly complete. In the great bulk of cases a trial balance was patently impossible, as most of the impersonal accounts are lacking, the personal accounts are not ruled off, and the work abounds in arithmetical slips and other blemishes. Some of the accounts may be in the currency of a sister province or of Britain, or a debit may be in £ s. d., and the credit in lbs. of tobacco. Even in the rare cases where full and logical entries in a copper-plate journal hold out promise of completeness, the ledgers do not in fact fulfil this promise—though the deficiency may conceivably be due to a book or pages having been lost. . . .

We can guess some of the reasons why colonial traders fell short of full double entry. Their whole method of business was often lax and careless, so precision in their accounts was hardly to be looked for; moreover, the snail-like pace of transport gave a good excuse for dilatory book-keeping. Few if any professional book-keepers were at hand to help. And traders must have felt it pointless to record matters that they could, thanks to the tiny scale of business, keep under close watch.

from STUDIES IN THE HISTORY OF ACCOUNTING, Edited by Littleton and Yamey, Richard D. Irwin, Inc., 1956.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Nonresident Income . . . Changes in Federal Net Income . . . Taxing the Record Owner—Real Estate Franchise Tax.

Nonresident Income

A member asked if a nonresident would be taxed on income he won on the \$64,000-question program. When he was advised that it would be subject to tax because it was earned in New York, he replied that the statutory provision of the law taxing nonresidents (Section 351) taxes income from property owned within the State, or income from a business, profession or occupation carried on within the State. How could a prize come within this statutory provision?

The power of the State to tax is not limited to persons. It embraces also all property and business within the State, and in the case of the income tax, it extends to all income earned within the

geographical boundaries of the State. By virtue of its jurisdiction over all income earned within the State, New York may tax nonresident persons earning or receiving such income. Our member is right when he points out that the winning of a prize is not specifically spelled out in the law itself as taxable income. The regulations (Article 415), however, say clearly that income earned within New York is taxable to a nonresident and certainly a prize won in New York is earned here. It would be a brave taxpayer who would question the power of the State to tax such income.

Changes in Federal Net Income

Under the franchise tax law (Section 211.3), a taxpayer is required to report to the State Tax Commission changes made by the Treasury Department in net income reported by the taxpayer. The law provides that the taxpayer report the changes within 90 days after a final determination of the change, or on the next franchise tax report filed by the taxpayer, or at an earlier date if so required by the Tax Commission.

Thereafter the Tax Commission re-audits and restates the account of the taxpayer for taxes based upon the entire net income as changed. However, according to Section 212.4 the Tax Commission may not change the allocation upon which the allocation of income or capital was made, upon which the original assessment was based.

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Mr. Harrow is a past Vice-President of the Society. He is a member of the Society's Committees on Meetings and Committee Operations, and had served for a number of years on the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

One of our members submits an interesting situation with respect to this provision in the law. A New York corporation does no business in New York but does carry on business in New Jersey. As a New York corporation it was nevertheless subject to the franchise tax and it paid a minimum tax. For a particular year the corporation showed a net loss and it did not work out any allocation knowing that it would be required to pay only a minimum tax. After an audit by the Treasury Department which resulted in an increase in entire net income, the Tax Commission held that the corporation was subject to tax on the income basis without any change in the allocation upon which the original assessment was based as provided in Section 212.4. Furthermore, it refused to allow the taxpayer to allocate any of its income even though the taxpayer did all of its business outside the State, and maintained a permanent and continuous place of business outside the State. Can they do that to you? asks our member.

In our opinion the taxpayer could prevail upon the Tax Commission to look into the equities in this situation. In the first place, the taxpayer had not at the time of filing the original return allocated either income or capital. Section 212.4 prohibits the Tax Commission from changing the allocation of income or capital on the original return. In this situation there was no such allocation. Furthermore the statute does not specifically prohibit the taxpayer from changing an allocation. It is only the Tax Commission that may not disturb the original allocation. Presented in its proper light, the situation is not without hope for the taxpayer.

Taxing the Record Owner—Real Estate Franchise Tax

A corporation which is the record owner of real estate under an agreement

or arrangement that the beneficial interest belongs to others is taxable as though the corporation itself were the beneficial owner of the real estate. Any net income derived therefrom by the beneficial owners is regarded as a dividend distribution and taxed accordingly to the corporation. A specific provision in Section 182 so provides. It was intended to apply to dummy corporations, but a literal application of the law can result in some inequities.

For example, suppose a corporation wishes to acquire some property at a cost of a million dollars. It does not have enough cash with which to swing the deal and so enters into a joint venture with B and C, whereby the latter are each to receive a 12½% participation in the profits and losses of the venture. In the first year, B and C receive their share of the net profits and also a return of a portion of their investment. The corporation had refinanced a mortgage on the property and received enough cash to make a capital distribution to the participants. In the following year the property was sold at a substantial profit. The corporation made a distribution of the profit to the co-venturers as well as the balance of the capital investment.

The Tax Commission ignored the joint-venture arrangement. Instead, it invoked Section 182 and held that as the record owner it was the corporation that earned the entire profit. The distribution to the co-venturers was deemed to be a dividend and taxable to the corporation.

In our opinion Section 182 was not intended to apply to a bona fide joint-venture. It was intended to cover the common situation of stockholders who purchase property and take title in the name of a corporation, they being the beneficial owners.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, C.P.A.

Certificate Where Part of Examination Is Made by Another Accountant

It is not unusual for a public accountant to report on financial statements, part of the examination of which has been made by other public accountants. The accounts of an out-of-town branch, division, or subsidiary may be examined by auditors located in or near the branch, division, or subsidiary. Sometimes the out-of-town auditor is engaged by the principal accountant, who reviews the work of the other accountant and pays his fee. In other cases the client engages the out-of-town accountant, whose report is made available to the principal accountant as a basis for reporting upon the over-all or consolidated financial statements. The variations in these arrangements are almost endless.

The Red Bank Oil Case. The SEC has said little in its published decisions about an accountant reporting on financial statements where part of the examination is made by another accountant. The Commission, however, issued a decision in the Red Bank Oil Company

case * which involved a number of accounting questions including reliance upon other auditors.

The principal accountant in this case was an accountant in Dallas, Texas. This accountant did not audit the Houston unit of a consolidated subsidiary, which unit was audited by a firm of accountants located in that city. The principal accountant incorporated in his work papers the audit report for that unit prepared by the Houston auditors. The Houston unit accounted for 70 per cent of consolidated sales and 45 per cent of consolidated assets. The Dallas auditors did not disclose in their certificate the fact that they relied on other accountants. The SEC said that it doubted the propriety of the principal accountant undertaking to express his opinion with respect to financial statements when, as to so large a percentage of the revenues and assets, his opinion

EDITOR'S NOTE: Mr. Rappaport was unable to submit this month's issue of his Department because of his absence abroad on a professional engagement. The current issue is a reprint, selected by your editor with permission, of a section of Mr. Rappaport's book, *SEC Accounting Practice And Procedure* (The Ronald Press Company, 1956).

* 21 SEC 695 (1946).

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is founded "merely on the reports of other accountants not subject to his supervision, control or direction."

According to the SEC, the principal accountant was not familiar with the Houston unit's accounts and he was satisfied merely to incorporate them bodily in his working papers and overall statements without further study. It appeared that he did not make any effort to determine whether the federal government sales were subject to renegotiation but accepted the Houston auditor's footnote to the effect that no provision had been made for renegotiation. The Dallas auditors did not know what inventory procedures were followed by the Houston auditors—did not, in fact, even know the basis used in determining costs. The SEC observed:

We think it wholly clear that where an accountant undertakes to express his opinion in part in reliance on reports of other accountants, it is essential that he have far more knowledge of the underlying facts and of the accounting principles followed than was exhibited here. Lacking such knowledge, it is impossible for him to express an informed judgment as to whether the figures reported to him by other accountants have been properly included in the consolidated statements. . . . We also believe that the principal accountant is not in a position to express an informed opinion as to the financial statements where he excluded from his review so large a part of the revenues and assets.

Does the SEC's decision mean that when the over-all examination has been made by more than one accountant, the principal accountant must state in his report the extent to which parts of the examination have been made by other firms? As will appear from the discussion below, the answer to this question must be in the negative, in the opinion of this author.

Regulation S-X. In 1950 (about four years after the Red Bank Oil case) the SEC revised its basic accounting regula-

tion, Regulation S-X, and inserted a new provision (Rule 2.05) dealing with certification of financial statements by more than one accountant, providing as follows:

If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificate of such other accountant shall be filed (and the provisions of rules 2.01 and 2.02 shall be applicable thereto); however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him.

Rule 2.05 (quoted above) is the most recent formal expression by the SEC on an examination made by more than one accountant. To the extent that it conflicts with the decision in the Red Bank Oil case, the author believes that Rule 2.05 is controlling. The Commission's present position appears to be this: the accountant is not required to make reference in his certificate to the fact that part of the examination has been made by another firm or firms. If, however, the principal accountant reports that others have participated in the over-all examination, then, in an SEC filing, these are the alternatives: (1) the certificates of the other participating auditors must be furnished, and these certificates are subject to the same rules as are applicable to the certificate of the principal accountant; or (2) the principal accountant must assume responsibility for the work done by the other auditors in the same manner as though the work had been done by him.

The author believes that the principal accountant does not have to disclose in

his report the participation by others in the over-all examination when the principal accountant engages the other auditors, plans the work to be done by them, reviews their work, receives the report directly from the other accountants, and pays the fee for the examination made by the other accountants. On the other hand, when the out-of-town accountant is engaged by the client, the principal accountant has no hand in planning the work, the other accountant reports directly to the client, and his work is not reviewed by the principal accountant, the principal accountant should disclose in his certificate the fact that he relied upon an examination made by another accountant. In the latter situation the principal accountant customarily does not assume responsibility for the work done by the other accountant. In these circumstances the report of the principal accountant will read somewhat as follows:

We have examined the consolidated balance sheet of Company A and its subsidiaries as of (date) and the related statements of income and surplus for the (period). We were furnished with financial statements of Canadian Subsidiary B as of (date) and for the (period), together with the report thereon dated of Messrs. X, Y and Z, chartered accountants. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, based upon our examination and upon the afore-mentioned report of chartered accountants, the accompanying financial statements present fairly, etc.

A certificate along these lines, filed with SEC, would have to be accompanied by a report of the named chartered accountants, since the principal accountant does not assume responsibility for their examination.

The certificate of the chartered or other accountants—if intended for in-

clusion in a 1933 Act filing—might read as follows:

We have examined the balance sheet of X Corporation as at (date) and the related statements of income and earned surplus for the (period). Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforesaid financial statements present fairly the financial position of X Corporation at (date) and the results of its operations for the (period), in conformity with generally accepted accounting principles applied on a consistent basis.

Reference has been made above to two types of arrangements between the principal accountant and the other accountants. In practice all kinds of variations in arrangements are possible. What the principal accountant should do in a particular case and what he should say in his report would depend on the circumstances in each case.

Occasionally the principal accountant may conclude that the circumstances justify his accepting responsibility for the work performed by other accountants, as contemplated by the SEC rule. The following is a typical form illustrating how this may be accomplished:

We have examined, etc. . . . Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accounts of the English subsidiary were examined or tested by other public (or chartered) accountants. We have reviewed the report relating to such examination and it is our opinion that generally accepted accounting procedures have been followed in the statements contained therein, and we have, therefore, accepted such statements for the purpose of consolidation as though the examination had been made by us.

In our opinion, etc. . . .

Desirability of Disclosure in View of Legal Precedent. From the view-

point of protecting the certifying accountant, a case** decided by the Court of Appeals of Ohio demonstrated the desirability of disclosing the fact of reliance on other auditors. The defendant in that case had signed a certificate reading as follows:

We hereby certify that we have examined the books of account and record of [name of company] and its American subsidiary company at December 31, 1929, and have received statements from abroad with respect to the foreign constituent companies as of the same date. Based upon our examination and information submitted to us, it is our opinion that the annexed consolidated balance sheet sets forth the financial condition of the combined companies at the date stated, and that the related consolidated income and surplus account is correct.

The defendants had certified that the net income for the years 1929 and 1930 had been in excess of \$20,000,000. A subsequent audit by other accountants revealed annual net earnings for the years involved to be approximately \$8,000,000. The plaintiff brought an action for damages for fraudulent misrepresentations on the part of the accountants. The plaintiff alleged that the certificates made by the defendant accountants were fraudulent, in that the defendants purported to have knowledge of the facts when in truth the defendants had no such knowledge, and that the fraud was not discovered until after the suicide of Ivar Krueger, which occurred in Paris in 1932.

The Court rules for the accountant-defendants, saying, in part:

If certified public accountants examine the books and records of a corporation and certify that the balance sheet reflects the true condition of the books and records examined, and there is a substantial variation between the balance sheet and such books and records, an action would no doubt lie against the accountants, where the certification was made

knowingly, or where there was a pretense of knowledge when in fact they had no knowledge.

In the instant case, however, the certificate made by [the certifying accountants] clearly states that it is based both upon an examination of records and upon statements received from abroad with respect to the foreign constituent companies. The language used in the certificates gives rise to the indisputable inference that the accountants had not examined the books and records of the foreign constituent companies.

The records do not establish fraud or any false or fraudulent statements in relation to the examination actually made of the books and records in this country. We do not think that the defendants can be charged with fraud under these certificates by the very language used therein, when they in fact disclose that some of the information and statements came from abroad. It is obvious that the accountants in this case could not know whether or not the information from abroad was accurate or inaccurate, and, inasmuch as they disclose that the certificates were based partly on information so received, there was no pretense of knowledge as to the information received which would make defendants liable.

Disclosure of Proportion of Overall Examination Made by Other Accountants. When a significant portion of an examination of financial statements is made by other public accountants, some accountants think it is not enough to say in their certificates that part of the examination was made by others. In that case, these accountants believe that there should be an indication of the proportion of the over-all examination that was made by others. Customarily this disclosure in the certificate of the principal accountant takes the form of a statement concerning the amount or percentage of assets, or net assets, or revenues, or net income represented by the subsidiaries, divisions, or branches examined by other accountants. This disclosure is not made because of any SEC

** *Beardsley v. Ernst*, 47 Ohio App. 241 (1934).

requirement; it arises rather from the desire of the principal accountant to put the reader on notice that a significant portion of the total examination was made by others. Following is the accountant's certificate appearing in a recent prospectus which indicates how the disclosure in question may be made:

We have examined the accompanying consolidated balance sheet of Corporation and its subsidiaries at (date) and the related consolidated statements of income and earned surplus for the years 19... through 19... Our examination, which covered the financial statements of the parent company and two of the five consolidated

subsidiaries, was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records of these companies and such other auditing procedures as we considered necessary in the circumstances. The financial statements of the three consolidated subsidiaries not examined by us (representing approximately ___ per cent of the consolidated net assets and approximately ___ per cent of the consolidated net income) were examined by other certified public accountants whose reports on their examinations were furnished to us.

In our opinion, based upon our examination and upon the reports of other certified public accountants, the accompanying financial statements present fairly, etc.

Accounting Experience

It is possible for an individual to be employed in public accountancy for several years without participating in such important aspects of practice as the development of audit programs or the drafting of audit reports. In contrast, he might, with different assignments, participate in such activities after only a few months of employment. . . .

Experience acquired through self-employment presents another problem. It is apparent that a person who obtains experience only through practice on his own account does not have the advantages of guidance and exposure to the experience of others.

Another problem relates to the nature of the practice of the employing firm. It is apparent, for example, that employment by a firm which does only monthly bookkeeping or write-up work can contribute little to the development of ability in application of auditing procedures, the preparation of audit reports, or the development of an independent objective attitude. Specialization of the employing firm, by type of clientele, may also limit the variety and breadth of the employee's experience.

The training practices of the employing firm may also have considerable effect upon the value of accounting experience. Rotation of assignments provides exposure to a variety of problems as contrasted with continued assignment to the same or similar engagements. Also existence of in-service training programs may be important. . . . A program which requires familiarity with current literature and professional developments and which provides opportunity for staff discussions is much more valuable than mere indoctrination in the procedures and practices of the particular firm.

*from the Commission's Report on STANDARDS OF EDUCATION
AND EXPERIENCE FOR CPAs, University of Michigan, 1956.*

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Errors in Financial Statement Drafts . . . Requests for Extensions for Filing Tax Returns . . . Time Budgets on Audits.

Errors in Financial Statement Drafts

Financial statement drafts turned in by staff men for review and typing frequently contain mathematical errors of a minor nature as in increase-decrease figures, percentages, transpositions of prior period data, etc. These errors are picked up by a reviewer or comptometrist before or after the statements are typed, dependent on a firm's policy. Some firms follow the latter procedure on the ground that typewritten statements are more convenient for review, and speculate on whether or not changes may be necessary in the typed statements.

Regardless of the policy followed, but more importantly in the latter instance

where corrections are more difficult, errors that are found should be reviewed with the object of spotting cases of chronic carelessness. This can be accomplished easily if the reviewer or figure checker prepares a correction form listing the errors found.

The "errors" form should not be disposed of after the corrections have been made but should be filed (grouped according to individual staff men) for later review. Thus, at some convenient time the individual folders can be reviewed and observations made as to the frequency of errors made by each man. This provides an opportunity for a constructive session with the man involved to display the record, discuss the causes, and to point out the need for proving figures and greater carefulness in the completion of financial statements.

MAX BLOCK, C.P.A. (N. Y., Pa.), is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Requests for Extensions for Filing Tax Returns—Controls

Where it has become advisable to obtain an extension for the filing of tax returns, and such request is made, a control problem arises. It becomes necessary to make sure that wherever a client

Administration of a CPA Practice

is to execute and mail a request form and, where required, a tentative return, the accountant is informed that it has been done, and the date thereof. This information not only advises the accountant that the required action has been taken, but the notation of the date may be evidence, if the mailing of the request and return to the tax department is lost, that such forms were placed in the mail box.

For the latter purpose, a receipt form should be sent to the taxpayer, to be filled out by him and returned to the accountant. The receipt should be in the form of a return post card so that it will have an imprinted mailing date when returned. As a minimum, the receipt form should contain this data:

Name of client

Type of return and tax year

Address of tax department office

Date mailed to tax department

Mailed by

This record in an accountant's file might help prove the mailing of the forms should the Treasury claim non-receipt. It may also serve to assure timely mailing by the taxpayer and com-

pletes the accountant's records as to the extension request. A similar post card form may be used as a receipt for income tax returns.

Time Budgets on Audits

While it is not desirable to pressure staff men to complete engagements within specified time limits, it nevertheless may be practical that they know that a reasonable time limit exists and what it is. This is especially important where engagements are undertaken on a fixed-fee or approximate-fee basis. Moreover, where advance scheduling of men is necessary, the approximate completion date is important to meet other engagement dates within a reasonable time limit.

To this end, the time limits should be communicated at the inception of the audit to the in-charge accountant and, if possible, discussed with him. Reference to prior time records may be helpful.

It may also be helpful to give the staff men a written time budget, for them to refer to occasionally, to gauge their progress and to discuss unreasonable lags, as soon as recognized, with the supervising partner or other supervisor.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Benefit Charges to Employers' Accounts . . . Workmen's Compensation and Disability Benefits . . . Employee Welfare Funds.

Benefit Charges to Employers' Accounts

Under the New York Unemployment Insurance Law, debits are made to employers' individual accounts after benefits are paid to former employees. These benefit charges are made in accordance with section 581-1(e) of the Law. The credits to the employer's account are based on timely payments by the employer of unemployment insurance contributions excluding the subsidiary contribution amount. The balance then remaining is used to determine the benefit factor, the size of which is an important element in the make-up of the contribution payment rate of the employer.

Both employers and the unemployment insurance law administrators have

found some difficulty in ascertaining whether or not the employers' accounts have been properly charged with benefits paid to former employees who had been in the employ of more than a single employer during a base period. In many instances the claimant may have been in the employ of several employers in the same day or week. Questions arose as to which of the employers could be charged. The new amendment to the Law provides, effective July 1, 1957, that for benefits paid to a claimant who had more than one employer on a given day or in a particular week during the base period, the charges are to be prorated among all the employers in the given period, if the commissioner is unable to charge the benefits to a single employer.

Inasmuch as every benefit payment must be charged either to an employer's individual account or, in the event an employer's account shows a negative balance, to the General Account, these charges must be watched closely and checked regularly by the employer or his accountant. An omission of such procedure may result in payment of unemployment insurance contributions at a much higher rate than would otherwise be required.

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Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of its Subcommittee on Unemployment Insurance.

A recent decision of the Unemployment Insurance Appeal Board in case #59,640-57, handed down May 17, 1957, indicates that this section of the Law is in need of a further amendment to protect employers' accounts from "experience rating charges" in cases where the employer would have been in a position to offer employment to the benefit claimant if notification had been received of the claimant's application for benefits and the payment of such benefits. In this case the Referee sustained the employer's protest, stating in his opinion:

"I believe the employer's objection to the experience rating charges is well founded. Had it known claimant was receiving benefits during the period in question, it would have offered him re-employment. In that event, if claimant had refused the offer he might have subjected himself to disqualification from the receipt of benefits and the employer's account would not have been charged. . . ."

However, the Appeal Board overruled the Referee, and sustained the Industrial Commissioner in charging the benefits paid to the employer's account on the ground that there was no statutory authority for the deletion of "charges" under these circumstances.

Workmen's Compensation and Disability Benefits

The Governor signed the Disability Benefits bill to raise the compulsory maximum sickness and non-occupational disability benefit rate from \$40 to \$45 per week, and the minimum from \$10 to

\$20 per week, effective July 1, 1957. However, he vetoed the measure to raise the maximum workmens' compensation occupational disability benefit rate from \$36 to \$45 per week and the minimum from \$12 to \$20 per week. The basis of the veto was a section in the bill that would permit appeals from decisions of the Workmens Compensation Board to the Courts on questions of fact, when the Board's decision is not unanimous or where the decision reverses or modifies findings of the referee. This matter of raising maximum workmens compensation law disability benefits is on the agenda of the special session of the State Legislature.

The maximum workmens compensation benefit award in disfigurement cases has been raised from \$3,500 to \$5,000, effective September 1, 1957.

Employee Welfare Funds

A bill was signed by the Governor amending the banking and insurance law in relation to the registration, examination and supervision of employee welfare funds. Certain ambiguous provisions contained in the original statute relating to the registration requirements of certain welfare funds are clarified. This bill does not bring under regulation those employee welfare funds which are unilaterally administered. Those funds that are administered jointly by employers and unions are regulated by this legislation. Such funds are now required to issue and publicize reports and make available to contributors information about their finances. Violation of the regulations is made a misdemeanor.

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Burden of Proof — Accumulated Earnings Cases . . . Disallowance of Surtax Exemption and Accumulated Earnings Credit . . . The Five Year Rule in Spin-Offs . . . Appreciated Treasury Stock as Compensation . . . Consolidated Return Treatment of Subsidiary's Cancellation of Parent Company's Debt . . . What is "Support" of a Dependent? . . . Exchange of Stock Through Partnership Liquidation . . . Employees' Plans.

Burden of Proof—Accumulated Earnings Cases

In deciding a case under Sec. 102 IRC 1939, the Tax Court has ruled that the provisions of Sec. 534, IRC 1954 (which are retroactive under P.L. 367, 84th Cong. 1st Sess.) apply only to the shifting of the burden of proof with respect to accumulation of profits beyond the reasonable needs of the business.

RICHARD S. HELSTEIN, C.P.A., has been a member of our Society since 1940. He has been a member of the Committee on Federal Taxation, as well as various other committees. He is presently a member of the Committee on Publications.

Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Co.

There is no shifting of the burden of proof with respect to the question of whether a corporation is availed of for the purpose of escaping the imposition of surtax upon its shareholders.

Thus, although a taxpayer may prevail because the Commissioner fails to prove that there was an unreasonable accumulation of earnings, the taxpayer still has the ultimate burden of proving the prime requirement: that the corporation was not formed or availed of to save the stockholders' tax upon dividends.

The significance of this decision is rather indeterminate. It clarifies, procedurally, the question of where the burden of proof lies in each of the two phases of a Sec. 531 proceeding. It makes clear that the establishment of reasonable accumulation is not in itself presumptive of the non-applicability of the penalty tax. However, it may have no effect upon the end result.

Even if it is found that a corporation is availed of for the interdicted purpose,

but that its accumulation of earnings and profits are needed in the business, the Accumulated Earnings Credit, under Sec. 535(c)(1), would eliminate that part of its earnings needed in the business from income subject to the penalty tax. If all of its accumulated earnings and profits are needed in the business, there would be no tax under Sec. 531. (Of course there was available no such "credit" under Sec. 102. Either all or none of the Sec. 102 income was subject to the penalty tax.)

In its determination that the taxpayer in this case was subject to Sec. 102, it was held that retention of earnings by the corporation under a plan to purchase the interest of its major shareholder was not a reasonable business need, but rather a benefit for the stockholders. (*Pelton Steel Casting Co.*, 28 TC No. 20)

Disallowance of Surtax Exemption and Accumulated Earnings Credit

A corporation formed a wholly-owned subsidiary to act as sales agent on a commission basis. The only asset transferred to the subsidiary was cash (to be used, we presume, for working capital). The sales agency owned no physical assets, since it leased its equipment and facilities from the parent company.

However, the lease agreement appears to have been disastrous in that it caused the loss to the subsidiary of its surtax exemption and accumulated earnings credit.

The Commissioner ruled that on the basis of *Estate of Charles H. Sanford v. Com.* (308 U.S. 39, 1939) the lease of facilities constituted a "transfer" of property within the meaning of Sec. 1551, IRC 1954 (Rev. Rul. 57-202, IRB 1957-20,12).

This appears to be a rather inapt basis for the ruling, even if it is equitable.

The *Sanford* case concerned the question of when a trust became taxable under the gift tax law. The doctrine cited, that "the essence of a transfer is the passage of control over the economic benefits of property rather than any technical changes in its title," was used to determine how the retention of power in the donor to modify an inter-vivos trust affected its taxability as a gift. It was held that as long as the donor gave up the economic benefits irrevocably, there was a gift.

But in the instant situation there was no irrevocable transfer of property and the parent corporation still enjoyed the economic benefits of the rent.

The Five Year Rule in Spin-Offs

An automobile dealer had been operating a franchise from two separate locations for more than five years prior to 1956. In 1954, it acquired a second franchise for another type automobile. It consolidated its sales of automobiles under its first franchise at one location, and sold under the newly acquired franchise from the second location. In 1956, the first franchise was transferred to a new corporation in exchange for stock which was in turn distributed pro rata to the stockholders of the old corporation.

The sale of the property for stock to the new corporation was tax free to the old corporation under Section 351, IRC 1954, but the distribution of the stock did not qualify as a spin-off under Sec. 355, because the second franchise, retained by the old corporation, had not been operated for five years as contemplated by Sec. 355(b). The stockholders received a distribution taxable under Sec. 301 (Rev. Rul. 57-190, IRB 1957-19, 18).

Appreciated Treasury Stock as Compensation

Where a corporation's treasury stock has appreciated in value, it may distribute such stock as compensation and obtain a deduction for the appreciated value of the stock distributed, without paying tax upon the difference between cost to it and fair market value at the time of distribution.

Section 1032, IRC 1954, provides that no gain or loss shall be recognized to a corporation upon receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Regulation Sec. 1.1032-1, as finally adopted, states that the transfer by a corporation of treasury stock as compensation for services is considered a disposition of such shares for money or other property. Thus, no gain or loss will be recognized in connection with the increase in market value over cost of the shares distributed.

Consolidated Return Treatment of Subsidiary's Cancellation of Parent Company's Debt

Where the advances to a parent company from its subsidiary exceed the basis of the subsidiary's stock in the parent's hands, and where that debt is cancelled during a taxable year for which a consolidated return is filed, the excess of the cancelled debt over the basis of the subsidiary's stock is to be reported in the consolidated return as gain from the sale or exchange of property.

It cannot be eliminated under Regs. Sec. 1.1502-31(b)(2)(iii)(a), since if it were, the gain to the parent company would escape taxation upon subsequent sale or other disposition of the subsidiary's stock. (Rev. Rul. 57-201, IRB 1957-20, 10)

What is "Support" of a Dependent?

It has been established in several Tax Court decisions that expenses incurred

to support children are those expenditures for "necessities."

In deciding whether a divorced mother or the father was entitled to a dependency credit for their child, it was necessary to determine which parent contributed the more to the boy's support. In computing the mother's expenditures, the District Court excluded as items not being necessities, the purchase of a Cris-Craft, a rifle and a lawnmower, but allowed the purchase of a Lionel train, track and equipment. (*Flowers v. U.S.*, D.C. West. Pa. 4/3/57)

We now need a definition from the Tax Court of "necessities."

Exchange of Stock Through Partnership Liquidation

Two equal partners each owned one-half interests in two corporations. In order to terminate their association, they both contributed to the partnership their stockholdings in the two corporations. The partnership was then dissolved, and in distributing the assets, all of the stock of one corporation was given to one partner, and the second partner received the stock of the other corporation. Thus there was effectuated a complete division of interests.

The only drawback is that the Commissioner denies that this is a tax free distribution by a partnership to a partner under Sec. 731, IRC 1954, and holds that under Regs. Sec. 1.731-1(c)(3) it is taxable as an exchange of property upon which gain or loss is realized. (Rev. Rul. 57-200, IRB 1957-20,9)

Employees' Plans

The Commissioner has issued a compilation of guides, rulings and decisions in connection with the qualification of stock bonus, pension, profit-sharing and annuity plans under the 1954 Code. (Rev. Rul. 57-163, IRB 1957-16,10)

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Management Services by CPAs: A Survey
by the AICPA Research Department
Voted Resolution—Board of Regents.

Management Services by CPAs: A Survey

In September 1956, a tentative draft of a pamphlet entitled *A Classification of Management Services by CPAs* was distributed to members of the American Institute of Certified Public Accountants with a request for comments.* Most of the letters received were general in character and many reflected doubts or fears about the desirability of extending professional practice into this area. It appeared that some of the writers had not examined the list in the light of the introductory section of the *Classification*, in which it was emphasized that the issuance of the *Classification* does not imply that any one CPA is qualified to perform any or all of the listed services, that the list does not imply that CPAs should make management decisions or perform management functions for the client, and that a CPA must make sure that, *under the circumstances*, he is clearly qualified to render a particular service before he offers it to the client.

In order to obtain a better balanced sample of opinion and to discover just what services were being rendered by CPAs, letters were written to over fifty individual members of the American Institute who are partners in moderate-size local accounting firms, asking for both general and specific comments on the *Classification*. The range in firm size was from one owner to fourteen partners, with an average of six partners. Thirty-three replies were received and analyzed. The thirty-three firms are located in twenty-three states, the largest number in any one state being seven.

It is well known that many of the large national accounting firms have established special divisions or special groups of staff members which offer a wide variety of management services. The extent to which the locally operating firms have developed a practice in this area has, however, not been known and it is hoped that this survey, small though it was, will serve to characterize the present situation and indicate the trend in the development of management services practice.

Each firm was asked to indicate whether it has or has not performed services for clients in each of 116 classifications. In interpreting the results, it

ED. NOTE: The text of this survey has been reprinted from the June 1957 issue of the *Journal of Accountancy*.

* Because of its tentative character, distribution of this draft of the *Classification* is limited to the membership of the American Institute of Certified Public Accountants.

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should be noted that an affirmative answer does not necessarily mean that the particular type of service is rendered frequently by the CPA or rendered at all levels of difficulty or complexity. It does mean, however, that the firm considers the type of service to be a legitimate part of its practice whenever the need of a client for such service is matched by the qualifications of the CPA firm to perform it.

Exhibit I (below) indicates the relative activity in each of the ten major groups into which the *Classification* was divided. It appears that services are rendered most commonly in the areas of finance, general management and administration, office management and purchasing; and least frequently in the areas of personnel, research and development, traffic and transportation, production, and sales.

Exhibit II (see pages 499 and 500) expands the analysis to the classes of management services, again following the language and organization of the *Classification*. In parentheses are examples of the relatively more common types of service in each class.

An "activity index" number in the exhibits shows the percentage which the number of affirmative answers actually received for all subdivisions of a group or class bears to the maximum number of affirmative answers if all firms replying had performed services in all of the subdivisions. The position of a group or class is, of course, affected by the particular types of service which were included in the *Classification*, but an attempt was made to include only those services which had been performed by one or more accounting firms.

Exhibit I

MAJOR GROUPS OF MANAGEMENT SERVICES RENDERED BY CPAs Ranked as to Activity

	<i>Activity Index *</i>
Finance	79
General Management and Administration	74
Office Management	71
Purchasing	64
Other Professional Services	50
Personnel	36
Research and Development	21
Traffic and Transportation	20
Production	18
Sales	16

* The activity index would be 100 if each accounting firm had rendered all of the types of service in each group.

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Exhibit II

CLASSES OF MANAGEMENT SERVICES RENDERED BY CPAS Ranked as to Activity

	<i>Activity Index *</i>
1. General Management and Administration—Use of Other Experts (Advice as to use of an attorney, appraiser or other specialists)	96
2. General Management and Administration—Special Investigations (Purchase or sale of business)	95
3. Office Management—Office Equipment (Advice as to machine bookkeeping and other office equipment)	93
4. Finance—Cost Accounting (Development of cost accounting methods and procedures, development of overhead allocation, design and installation of a cost accounting system, development of standard costs)	89
5. Finance—Financial Management—Business Organization and Reorganization (Advice as to type of business organization, advice and assistance as to sources of capital, advice as to types of securities to be issued, advice as to provisions of contracts and agreements)	88
6. Finance—Insurance (Advice as to fire, fidelity and casualty coverage, advice as to life insurance, advice as to records required for insurance purposes)	84
7. Finance—Pension and Profit-sharing Plans (Advice as to various types of plans)	82
8. Finance—Financial Management—Financing Current Operations (Study of working capital requirements, advice and assistance as to sources of working capital, advice as to dividend policy, advice as to financing purchases of plant and equipment, advice as to investment of idle funds)	81
9. Office Management—Systems and Records (Designing and assisting in the installation of the general accounting system, survey of office paper work, survey of filing system and records retention)	79
10. Finance—Government Contracts (Assistance in contract negotiation, renegotiation and termination, analysis of costs under government contract regulations)	79
11. Finance—Budgeting (Advice and assistance in design and preparation of operating, cash and capital budgets, and in the development of a flexible budget and budgetary control)	76
12. Finance—Financial Management—Analysis of Results of Operations (Analysis of financial and operating statements, securing comparable industry figures)	73
13. General Management and Administration—Management Controls (Survey and design of system of internal reporting, establishment of cost and expense controls)	73
14. Office Management—Office Administration (Survey of office organization, analysis of workload of office personnel, evaluation of personnel)	72
15. General Management and Administration—Public Relations (Reports to stockholders and employees)	70
16. Finance—Financial Management—Long-term Financing (Study of long-term financial requirements)	70
17. Personnel—Compensation (Advice as to compensation for various types of work, advice as to wage incentive programs, calculation of distributions under profit-sharing plans, advice as to employee benefit programs)	67
18. Finance—Credits and Collections (Advice as to credit policy, survey of collection operations)	66

* The activity index would be 100 if each accounting firm had rendered all of the types of service in each class.

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Exhibit II (Continued)

	Activity Index
19. Purchasing (Survey of purchasing procedure)	64
20. General Management and Administration—General Management Policies (Survey of management policies, advice as to expansion or contraction, advice as to general business and industry conditions)	62
21. Personnel—Training (Instruction of accounting personnel in the operation of the accounting system)	57
22. Personnel—Recruitment (Recruiting or interviewing prospective accounting personnel)	53
23. General Management and Administration—Internal Organization (Survey of internal organization)	53
24. Other Professional Services (Assistance in rehabilitating a business, arbitrating disputes)	50
25. Office Management—Office Layout and Space Utilization (Survey of office layout and space utilization, study of office space requirements)	44
26. Personnel—Classification and Evaluation (Preparation of job classification)	31
27. Sales—Sales Management (Advice as to establishing prices for products and merchandise, analysis of sales results)	28
28. Production—Production Control (Development of inventory controls, survey of production records, development of production statistics)	26
29. Traffic and Transportation—Transportation Equipment (Study of equipment operating costs, study of equipment costs and lives)	25
30. Production—Materials Handling and Control (Study of material accounting, survey of warehouse layout and space utilization, survey of material handling)	23
31. Research and Development (Developing records and controls for research and development programs)	21
32. Personnel—Safety and Health Programs (Advice as to safety and health programs)	21
33. Traffic and Transportation—Fleet Management (Survey of fleet operation)	18
34. Sales—Distribution and Merchandising (Development of distribution costs and statistics, survey of delivery problems, study of distribution methods)	17
35. Production—Plant and Equipment (Studies of economic justification of plant additions, investigation of new plant location)	15
36. Production—Production Administration (Survey of production department organization)	12
37. Sales—Advertising (Development of advertising control)	12
38. Traffic and Transportation—Traffic Management (Survey of traffic management)	12
39. Sales—Packaging and Shipping (Survey of shipping methods and costs)	11
40. Production—Production Methods and Standards (Time and motion studies, development of production standards, survey and evaluation of production methods)	10
41. Personnel—Industrial Relations (Advice as to the labor union contracts, computing probable cost of guaranteed annual wage agreements and of other "fringe" benefits, preparing evidence as to "ability to pay" wage increases in labor union negotiations)	9
42. Sales—Market Research (Conducting market research for products and services)	7
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Only four of the 116 types of service included in the *Classification* were not rendered by at least one firm. They were: (1) advice as to types of production equipment; (2) advice as to packaging methods; (3) market research involving analysis of markets; and (4) conducting an employee attitude survey.

It is obvious, as would have been expected, that the most commonly rendered services are those which are directly or indirectly related to accounting or auditing problems, and for the performance of which the individual CPA concerned considers himself competent by training and experience. This explains the high position of services in the areas of finance, general management and administration, and office management.

Various factors may account for the low position in the scale of certain other types of service. Lack of technical qualifications may explain the position of production methods and standards, and of market research. Infrequency of the problem among the clients of moderate-size accounting firms may account for the low position of research and development, and fleet management. The failure to be more active in the area of sales department problems is more difficult to understand since many aspects of sales analysis are well within the competence of public accountants; it has been suggested as a reason that accountants and sales personnel "do not speak the same language."

Comments on Management Services

Most of the comments on the *Classification* included some general discussion of the extension of accounting practice into the area of management services. Some indicated enthusiasm, while others expressed less favorable opinions. Some firms have already developed an extensive practice in such

services, while others are in the exploratory stage. The following quotations from the letters illustrate some of these variations:

This office is optimistic about the potentialities of management service. During the past six months we have received many favorable reactions from clients. . . . It seems to me that CPAs are in an ideal position to render important management services to their clients, but such engagements should be limited to those areas where they are qualified to do a competent job.

Another important aspect of our approach to the management service problem has been our policy to undertake work only in areas in which at least one of our partners is competent. . . . From time to time, however, we have suggested to clients that . . . specialized services are available and have assisted in the selection of consultants specializing in the particular field.

Many of our partners do not agree with me fully but I am inclined to lean toward that body of opinion which feels that certified public accountants should go slowly in entering the field of general management consultation. I would regret seeing our standing as public accountants jeopardized by having a great deal of management advice rendered where the background and ability of the accountant do not warrant such services and result in unsound and impractical advice.

It seems to us that a large part of any practice serving local and smaller businesses is going to be in the general area of management services.

We believe that all accounting firms should keep alert to the various services which might be rendered to the mutual advantage of their clients and themselves. On the other hand, some of us with very small staffs must guard against taking on engagements for which we do not have trained personnel.

Our firm has always performed a considerable amount of the management services

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for our clients. The demands are increasing each year. . . . We find that our clients appreciate this service very much inasmuch as they can see immediate results in the betterment of their businesses. For a small firm such as ours, it is a very important field and complements tax work very smoothly.

. . . we have recently had some discussions as to how we would best proceed in expanding such service, either by assignment of a few of our present personnel to such work or by attempting to find someone qualified by experience and training to develop such service for us.

Our practice is generally with smaller businesses and most of our clients naturally turn to us for advice and assistance in most of the fields mentioned in the pamphlet.

In my opinion the field of so-called management services presents great opportunity to accounting firms serving small and medium-size business. However, it is a line of work which, in my judgment, should be approached with caution by reason of the fact, primarily, that there are relatively few certified public accountants having the type of "practical" experience necessary to be of service in respect of varied business problems.

The more I look at the *Classification* the more I realize how little we have done to show the client the importance of much of the help we so casually and informally drop in his lap, without either the client or ourselves thinking that what we are passing on is the distillation of the best we have acquired in years of experience and training.

Our partners are always looking for an opportunity to assist in management's problems and are, therefore, constantly advising the clients, either orally or by written memo, of possible ways in which we can be of service. This procedure has developed our relations with our clients to the point where they now consult us on practically all of their management problems.

It has been our practice for many years to consult and confer with our clients on the various matters set forth in the pamphlet. . . . A CPA must be more than someone who merely abstracts figures from the records. Due to the nature of his association with management, an accountant must be analytical and must know the manner in which management operates and the many problems that management must meet daily. Unless he does understand these problems, he cannot give a proper report or express an opinion regarding financial and operating statements.

We have, ever since our inception in 1932, extensively engaged in rendering these types of services. In fact, what reputation we enjoy has, in my opinion, resulted, to a material extent, from our activities in this field.

. . . my own opinion is that a new profession is in the embryonic stage, and before long will be born. Can CPAs be the legitimate parents? In other words, the challenge facing CPAs is that we prepare to perform in a field or fields wherein our training and experience do not qualify us. The fact that there may be no state legislation prohibiting us from so engaging does not justify our entry into such field or fields. . . . If CPAs are not careful, the public will be of the opinion that there is no distinction between CPAs and non-CPAs who engage in such fields of service. This would create confusion and perhaps lessen the public's respect for the CPA.

In numerous talks on management problems over the last seven years I have continually emphasized the need for preparedness, and the dangers of undertaking services that one may not be qualified to perform. . . .

There is very little in the *Classification* . . . that a member of our firm has not rendered at one time or another. . . . However, I hasten to add that our counseling on the greater number of items listed is confined to developing an awareness of the need for employing experts in the re-

spective fields and to the desirability of our serving in a liaison capacity.

... our firm has a standing committee, chaired by one of our younger partners, to continually initiate and study ideas on management service.

Specific Engagements

The CPAs who contributed to the survey were asked to indicate the extent to which management services were treated as specific engagements, as opposed to a part of the audit engagement. The answers as to the individual types of services were not numerous enough to justify detailed analysis but, roughly speaking, it appeared that around sixty per cent of such work was performed as specific engagements and forty per cent as a part of the audit. We believe from this and other sources of information that the trend is toward the treatment of management services as specific engagements with a separate bill being submitted for the work done. The variations in practice on this point are indicated by the following quotations from the letters which were received.

It is not the policy of our firm to accept separate engagements. . . . We believe that all our work is management service, including the regular auditing and tax services. We have taken a comprehensive approach to the problems of our clients.

In a substantial number of instances, we have been specifically engaged for management-type services and have charged specific and separate fees therefor. . . . In the instances where we are engaged on what might be termed a "package deal basis," both the aggregate of our annual retainer and the provision for upward adjustment therein are specifically and separately identified both in our clients' and our minds. . . .

Generally, such services are incidental to our regular responsibilities towards clients as auditors, supervising accountants and

tax men. . . . Usually I do not believe the client is particularly conscious of engaging us for management services representing a distinct departure from our normal accounting and tax services.

... we are in continuous contact with most of our clients and probably render billings four or five times during the year. Only the year-end work would be considered as audit or tax work; the remainder must necessarily be considered management services.

In only a few instances have we entered into separate engagements to perform management services where we have billed separately for such services. . . . It has been our general policy to charge our regular rates for such services rather than a stepped-up rate.

Most of the services were undertaken as specific engagements for which a separate fee was charged.

Many, if not all, of the services performed as a special assignment have also been performed in connection with the regular audit engagements, and the ensuing audit fees have taken into account these additional services.

Except for those services which, by their nature, are normally "rendered in conjunction with audit or tax work . . ." all other services are separately identified.

Only occasionally as in the case of a system installation do we make any separation.

Many of these services, of course, are rendered in conjunction with our audit or tax work, but we generally identify them separately on any statement for services performed. Very frequently, too, such services are instigated during one of the above types of engagement, and are then completed as a separate engagement at a later date.

Very few of our firm's management services are rendered as specific engagements for which a separate fee is charged.

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Most of them are rendered in a consulting capacity from time to time throughout the year and our fees are billed along with the fees for the annual audit.

In the past we have been too lax in further formalizing our service with a memo. As we are becoming more conscious of the need for specifically identifying our services we realize that much of the real help we have given to clients has been just a rather casual informal passing on of information.

Our services in those categories principally are rendered in connection with other work, but in almost every case the services rendered are separately identified

(but not separately priced) in the fee statements presented.

... our fees are billed periodically or at the end of the year, on the basis of time consumed. The special services ... are not billed separately. ...

Where the amounts are significant we often bill separately or separately state that portion of our bill which is for special work.

We cannot define our billing practice other than to say it has depended largely on the preferences of client management. ... Today, it is our policy to identify and classify when a useful purpose may be served by such information.

Voted Resolution—Board of Regents The University of the State of New York

Adopted March 29, 1957

Upon the report of the Regents Committee on Discipline, made in accordance with the provisions of chapter 514 of the Laws of 1945, it was

Voted, That the findings of the Certified Public Accountancy Committee on Grievances in the matter of the application for the revocation of the certified public accountant certificate heretofore granted to Ernest Zelnick, Brooklyn, be accepted and sustained; but that the recommendation of said committee, that the certified public accountant certificate heretofore issued to said Ernest Zelnick be revoked, be modified, and that certificate No. 12808, issued under

date of May 21, 1948 to said Ernest Zelnick, permitting him to practice as a certified public accountant in the State of New York, and his registration or registrations as a certified public accountant, wherever they may appear, be suspended for a period of one year from the date of service of the order effecting such suspension; and that the Commissioner of Education be empowered and directed to execute, for and on behalf of the Board of Regents, all orders necessary to accept the determination of said Committee on Grievances, as herein modified, and to carry out the terms of this vote.

Order of Suspension Served—April 23, 1957.

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